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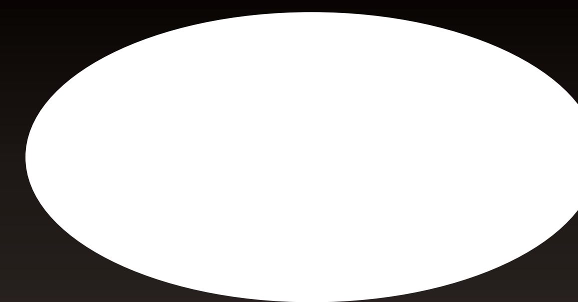

The Prudential Regulation of Equitable Life

Part II: Full Text of Representative Investigation

HC 809-II

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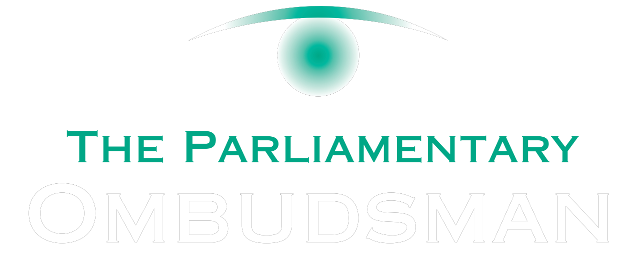

The Prudential Regulation of Equitable Life

Part II: Full Text of Representative Investigation

4th REPORT – SESSION 2002-2003

Presented to Parliament Pursuant to Section 10(4)
of the Parliamentary Commissioner Act 1967

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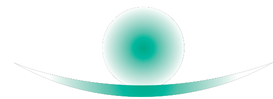
The Prudential Regulation of Equitable Life

THE PARLIAMENTARY OMBUDSMAN



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Case No. C.1597/01

The prudential regulation of Equitable Life

1. Mr P complained to my predecessor that the Financial Services Authority (FSA), acting on behalf of the Treasury, failed to take appropriate regulatory action which would have ensured that existing and potential policyholders were able to make fully informed decisions when purchasing new policies or annuities from the Equitable Life Assurance Society (Equitable). As a result, Equitable were able to continue to encourage him, and other investors like him, to purchase a with-profits annuity without a full understanding of the risks involved. He contended that, had he been aware of the true position, he would not have purchased such an annuity in June 2000. Having purchased the annuity, he was unable to transfer it to another insurer without penalty. He sought full redress.

2. The investigation began in December 2001 after my predecessor had obtained the comments of the Permanent Secretary at the Treasury. On taking up Mr P's complaint for investigation, my predecessor decided to limit the period under investigation to that from 1 January 1999 to 8 December 2000, which is from the point at which FSA began to conduct the prudential regulation of life insurance under contract from the Treasury until the closure of Equitable to new business. (The period coincided with that examined by FSA's own internal inquiry, as explained in paragraph 40, which had identified possible shortcomings in the prudential regulator's performance.) When I took up post in November 2002, the investigation was at an advanced stage. I carried out a careful review of the position and decided not to depart from my predecessor's decision on the period under investigation; to have done so would have meant virtually restarting the investigation, and delaying my report by many months. However, as the detailed chronology of events shows, we have in any event had to look back at some of the earlier events to gain a proper understanding of the background to the period under investigation. I have not put into this report every detail investigated by my staff, but I am satisfied that, on the basis of the evidence that we have seen, no matter of significance has been overlooked.

Jurisdiction

3. Section 5 of the Parliamentary Commissioner Act 1967 provides that I may investigate any action taken in the exercise of an administrative function by, or on behalf of, a government department or other public body listed in Schedule 2 to the Act as being within my jurisdiction. FSA are not so listed and so fall within my jurisdiction only in so far as they were acting on behalf of the Treasury as **prudential regulator** before 1 December 2001. The Personal Investment Authority (PIA), which until 1 December 2001 had ultimate responsibility for conduct of business regulation, the Government Actuary's Department (GAD), which provided professional actuarial advice to FSA, and Equitable themselves are not so listed and their actions are therefore not within my jurisdiction. Thus, in so far as a complaint might relate to the terms and conditions of Equitable's policies, or the nature or calculation (or actual amount) of annuities or dividends payable to policyholders, or the conduct of Equitable's business including their marketing, sales and advertising, whether of personal pension, additional voluntary contribution, or any other plans, or any regulatory issues arising from the conduct of their business, **I have no power to investigate** such matters.

4. Reference is made throughout this report to Equitable, PIA, FSA lawyers, GAD, and to FSA staff seconded to the PIA when acting as conduct of business regulator. I also refer to other bodies, including the Faculty of Actuaries and Institute of Actuaries (which I jointly refer to as the Faculty and Institute of Actuaries), Equitable's auditors, companies bidding to buy Equitable and law firms. I do so solely to put in context the actions of the Treasury or FSA **as prudential regulator** and since these bodies are all outside my jurisdiction, make no findings relating to their actions.

5. My remit is solely to investigate the administrative actions of those bodies within my jurisdiction. Under section 12(3) of the 1967 Act I may not question the merits of a discretionary decision taken without maladministration by such bodies; accordingly, providing the process by which the decision was reached was appropriate and the judgment reached was within the bounds of reasonable discretion, I cannot conclude that that decision was maladministrative. Further, the content of legislation or the possible need for its amendment are properly matters for Parliament to consider. Similarly, questions and disputes about the interpretation of legislation are matters for the courts to determine.

6. This means, therefore, that I cannot question the statutory regulatory framework (including the statutory content and requirements of financial accounts and regulatory returns), within which the FSA carried out their prudential regulatory functions, and which I set out in more detail below. The regulatory framework was, and remains, a matter for Parliament. I should also make clear that, as that framework has changed since December 2001, when the Financial Services and Markets Act 2000 was fully implemented, and the implementation of regulatory functions is no longer vested in a government department or any other body within my jurisdiction, I do not believe it would be appropriate for me to make recommendations regarding possible changes to practices and procedures by which those regulatory functions are exercised.

7. This report contains references to opinions and advice obtained by Equitable and provided to the Treasury (subsequently FSA) in the course of normal exchanges between a regulated body and their regulator and for the

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specific purpose of allowing the Treasury to fulfil their regulatory functions. I acknowledge that Equitable have waived privilege in this material only for that specific purpose, and that, by agreeing to the inclusion of the material in this report, which it was understood would be published, Equitable do not intend any wider or general waiver of privilege.

Statutory and administrative background

The regulatory framework

8. Until 1 December 2001, when the Financial Services and Markets Act 2000 came into force, life insurance companies such as Equitable were subject to two regulatory regimes: prudential regulation and conduct of business regulation. Prudential regulation is concerned essentially with the solvency of insurance companies (in prudential regulatory terms this means that the company is able to meet a number of regulatory requirements, principally the required minimum margin - see paragraph 22) and the soundness and prudence of their management; conduct of business regulation relates primarily to the marketing and sale of a company's products and the provision of related advice to current and potential investors.

9. The objective of prudential regulation is to guard against a number of possible dangers. These are, in essence:

a) that the insurance company might have insufficient assets to meet their contractual liabilities (the basic benefits provided under the policies and the reversionary bonuses)

b) that the insurance company might be unable to meet the reasonable expectations of policyholders and prospective policyholders (see paragraph 33).

10. The statutory framework which governed the regulation of Equitable before 1 December 2001 was, for prudential regulation, the Insurance Companies Act 1982 (the 1982 Act) and, for conduct of business regulation, the Financial Services Act 1986 (the 1986 Act). The detail of the regulatory regimes was set out in a number of applicable Statutory Instruments supplemented by other non-statutory material such as the Personal Investment Authority (PIA) Rules and the actuarial Guidance Notes (see paragraph 24). The 1982 Act vested in the Secretary of State for Trade and Industry certain authorisation and supervisory functions related to the solvency of life assurance companies.

11. In January 1998, as part of the preparations to establish a single financial services regulator operating on the basis of a single legislative framework (which eventually came fully into being on 1 December 2001), responsibility for prudential regulation passed from the Department of Trade and Industry (DTI) to the Treasury. On 1 January 1999 the Treasury contracted out their functions and powers in respect of prudential regulation (with some exceptions - see paragraph 25) to FSA. The transfer of functions was effected by means of the Contracting Out (Functions in Relation to Insurance) Order 1998 (SI 1998/2842), and a service level agreement dated 18 December 1998 (the agreement) between FSA and the Treasury. Under the terms of the agreement, FSA had to "*use its best endeavours*" to meet the relevant service standards, in Schedule 1 to the agreement, which detailed (amongst other things) a number of circumstances in which FSA were required to alert the Treasury to regulatory issues arising either in relation to the insurance industry or to an individual company. FSA were also required under the agreement to provide the Treasury with a quarterly written report on the exercise of the [contracted out] functions during each preceding period and such other reports as might from time to time be specified. During this period, while FSA were accountable to the Treasury for the effective exercise of the contracted-out functions, the Treasury remained responsible for the prudential regulation of insurance companies and Treasury Ministers remained answerable to Parliament for its proper operation; day to day supervision of the insurance companies was undertaken by FSA.

12. Responsibility for conduct of business regulation had, since 1994, rested with PIA, which was a self-regulatory organisation. From 1 June 1998 until 1 December 2001 PIA undertook that function through the PIA Board with staff seconded from the FSA. On 1 December 2001, with the full implementation of the Financial Services and Markets Act 2000, full responsibility for both prudential and conduct of business regulation passed to FSA as the new single regulator for the financial services industry.

13. On 1 January 1999, when the Treasury contracted out their prudential regulatory functions and powers to FSA, virtually all of the DTI staff who had been seconded to the Treasury to be responsible for regulation of insurance companies in Treasury's Insurance Directorate moved to FSA, where they joined with others to form FSA's prudential division. This meant that, while FSA became accountable to the Treasury for the effective exercise of the contracted out functions, the bulk of the staff carrying out the work continued in their same roles.

14. FSA's aim in respect of the powers and functions conferred on them was described in the standard service specification associated with the agreement as:

> "*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…*".

Key supporting objectives were set out and included: ensuring that persons or companies who are not fit and proper or appropriately resourced or otherwise able to satisfy the authorisation criteria do not carry on business in the UK; to regulate companies efficiently and effectively; to meet the industry's reasonable requests for information and advice, keeping the cost and

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inconvenience of regulation for insurers as low as is commensurate with effective consumer protection; and co-operating with the Treasury in seeking to deliver efficient operation of the single market. Key areas of work to be resourced during 1999 were: conduct of ongoing regulatory and related work to specified standards; supporting development of more effective and efficient regulatory procedures; and preparing for the new regulatory regime.

15. FSA's general responsibilities in this respect, as set out in the agreement, included prudential supervision of around 350 non-life companies, 200 life companies and 40 composite insurance groups, in addition to the supervision of Lloyds and some 80 companies in the London market. The agreement defined their key role as:

> "*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. 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.*"

16. The service standard specification said that: "*The supervisory process is in an ongoing state of development ... the performance measures ... will be kept under review and amended from time to time as agreed between the Treasury and the FSA*".

17. The agreement also set out FSA's key tasks, which included: "*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 GAD, particularly in the case of life insurance companies), and site visits*".

18. The exercise of the powers or discretion conferred upon FSA by the agreement was in turn delegated to FSA's Insurance Supervisory Committee (the Committee), which comprised the director of the prudential division, the heads of department of the life, non-life, and London market sectors, and each of their respective managers. The head of the policy co-ordination unit, the insurance advisers, and representatives of GAD and FSA's General Counsel's Division (to which I refer as FSA's legal division) also had a standing invitation to attend.

19. GAD provided technical support to FSA under the terms of a separate service level agreement (as they had previously done for both the Treasury and, before them, DTI). That agreement set out in detail the services GAD would provide. In particular, they would scrutinise the regulatory returns of insurance companies (see paragraph 26) and advise FSA's prudential division as to what action should be taken following that scrutiny. To ensure appropriate prioritising of their workload GAD would carry out a brief initial scrutiny of the annual regulatory returns and assign priority rankings from one (high - a company at serious risk of collapse) to five (low). They then used this to assess whether a detailed scrutiny was required, subject to any views of FSA, scrutinised the returns in priority order and reported the results to the prudential regulator in the form of a 'scrutiny report', which formed a key element of the prudential regulatory process. (In Equitable's case, GAD were required to complete an initial scrutiny report by the end of the August each year following submission of the annual returns, and a detailed scrutiny by the end of the following February.)

20. GAD, both on their own initiative and on request from the prudential regulator, provided advice on areas that would impact on a company's regulatory solvency (see paragraph 22) or on the reasonable expectations of its policyholders. To ensure that GAD were fully informed, FSA's prudential division were required to copy to them all relevant correspondence received from insurance companies. In addition, GAD provided guidelines to companies on good practice in relation to particular actuarial issues. Their staff worked closely in support of FSA's prudential division, accompanying them on visits to insurance companies and advising them on a range of policy and technical issues.

21. Statutory restrictions (Schedule 2B to the 1982 Act inserted in 1994) meant that the prudential regulator could disclose restricted information (as defined) to the conduct of business regulator only where it was considered that the disclosure would enable or assist PIA in discharging their functions in their capacity as a recognised self-regulating organisation. I understand that there had been no formal regular contacts between the prudential and conduct of business regulators prior to both functions being carried out by FSA staff.

Principal regulatory actuarial and accounting provisions

22. Section 32 of the 1982 Act required insurance companies to hold assets which exceeded their liabilities by at least the margin prescribed by regulations. That was known as the **required minimum margin** and had to be maintained throughout the year, and not just at the yearend. Within the life insurance industry and frequently within this report, the term 'insolvency' or 'regulatory insolvency' is commonly used to mean the inability of a company to meet certain regulatory requirements, including principally the required minimum margin. In this context, the term does not imply inability to meet liabilities as in the more widely understood Companies/Insolvency Acts meaning of the term, i.e. it is best understood as a regulatory trigger point or early warning mechanism. Section 32 makes it clear that breach

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of the required minimum margin might result in the prudential regulator requesting that a company provide it with a plan for the restoration of a sound financial position. The valuation of assets for the purpose of calculating the required minimum margin had to be in accordance with the Insurance Companies Regulations 1994 SI 1994/1516 (**the 1994 Regulations**). It was a further requirement that a specified proportion of the margin had to be covered by explicit available assets; in Equitable's case, as for most life companies, that proportion was one sixth. The remaining part could be covered by implicit items (assets which are intangible and relate, for example, to future profits from existing life business or hidden reserves resulting from the underestimation of assets or the overestimation of liabilities), although a section 68 order (see paragraph 25) in respect of those items had first to be obtained. A breach of Section 32 was one of a number of legal stages in an insurer's failure (these are listed in Appendix A).

23. Regulation 64 of the 1994 Regulations provided that the determination of long-term liabilities should be made on prudent actuarial principles, having due regard to the reasonable expectations of policyholders, and should include appropriate margins for adverse deviation of the relevant factors. It required that account should be taken of all prospective liabilities, including all guaranteed benefits and all options available to the policyholder under the terms of the contract.

24. This statutory requirement to include appropriate margins for adverse deviation of the relevant factors was understood by both regulators and actuaries as requiring not only the provision of such margins in each valuation factor but also that the valuation should be resilient to changes in circumstances, with special reference to more extreme changes to which a company might be vulnerable. The changes to be tested referred primarily to changes in investment conditions and the process of testing that a company was able to meet its regulatory solvency requirements in the event of significant hypothetical change in investment conditions was known as **resilience testing**. Monies set aside to ensure the company could cope with the adverse investment scenarios were known as **resilience reserves**, albeit part of the margins to meet resilience tests were often met by crediting 'excess' margins held elsewhere within the overall valuation basis. The 1994 Regulations did not indicate the range of eventualities that was to be allowed for in resilience testing; that was left to the professional judgment of the appointed actuary (see paragraph 27) and was the subject of one of a series of guidance notes (Guidance Note 8) issued to actuaries by the Faculty and Institute of Actuaries. GAD developed and kept under review guidelines as to the changes in market yields and equity prices that it might be prudent to take into account. They published the guidelines as letters (known as "*Dear Appointed Actuary*" (DAA) letters), sent to all appointed actuaries. While not mandatory, that guidance provided the de facto standard for prudent resilience testing. Advisory letter DAA10 from the Government Actuary, issued on 24 November 1998, amended the benchmark scenarios for resilience test 2. It said that, while the revised test was necessarily more complex, it was intended to avoid the unreasonable stringency which might apply if equity markets fell below their current levels. However, if applied to other types of business, it was not appropriate to include in the test any element which, taken overall, served to reduce the prudential effect of the test. FSA told my staff that an appointed actuary would be expected to use the most onerous of the tests; but it was open to the actuary to use an alternative basis for resilience testing, provided that the actuary could demonstrate to the satisfaction of GAD that the alternative was prudent and gave proper and meaningful implementation to the regulations.

25. Section 68 of the 1982 Act allowed for an order (a **section 68 order**) to be made which waived, or modified the application of, certain regulatory provisions of that Act. For legal reasons (namely the provisions of the Deregulation and Contracting Out Act 1994, whereby departments could not contract out powers to make or amend legislation), the power to make such orders could not be contracted out to FSA in January 1999 and so remained with the Treasury until 30 November 2001 (after which date FSA took on full regulatory powers - see paragraph 12). Under the agreement between FSA and the Treasury (see paragraph 11), however, it was for FSA first to consider an application for such an order. If they decided that the application met the relevant guidelines, they were to provide the Treasury with advice setting out the background to the application, a recommendation and a draft order in the form of a draft letter. It was then for the Treasury to consider the Order and (as specified under the terms of the agreement - see paragraph 11) "*clarify any points as necessary with FSA and/or Treasury solicitors and if satisfied, make the Order*". Guidance issued by DTI to the industry during their time as prudential regulator, i.e. before 1998, said: "*Orders in respect of future profits* [see paragraph 28] *and Zillmerising* [see paragraph 30] *will be readily available provided that the relevant requirements set out in this Guidance Note have been satisfied*". Some 116 section 68 orders were given in 1999 and 165 in 2000, of which about 10% related to future profits implicit items, the calculation of which was set out in the 1994 Regulations (see paragraph 22).

26. In addition to the annual report and accounts required under the Companies Act 1985 (**the statutory returns**), section 22 of the 1982 Act required a life insurance company to submit to the prudential regulator each year a series of reports known as **the regulatory returns**. The Insurance Companies (Accounts and Statements) Regulations 1996 (SI 1996/943) set out in detail the information required in those returns and the format in which it was to be presented. The regulatory returns were considerably longer and more detailed than the statutory returns (those for Equitable ran to some 400 pages for each of the relevant years). The returns were designed to show not only the company's current solvency position but also, by the application of the resilience tests, their sensitivity to possible future adverse changes in the markets. The regulatory returns were the main tool from which FSA's prudential division, acting on advice from

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GAD, formed a view as to a company's (then) present and future regulatory solvency. At the time of the events giving rise to Mr P's complaint, companies were required to submit their returns to FSA within six months of their financial year end (which in Equitable's case meant by 30 June).

27. The 1982 Act required every life company to nominate an actuary, known as an appointed actuary, whose designation had to be notified to the prudential regulator before it could become effective. Regulatory approval was not however required for the appointment, nor did the regulator have powers to seek an actuary's removal on 'fit and proper' grounds (see paragraphs 14 and 17). The appointed actuary was required to hold a valid practising certificate from the Faculty and Institute of Actuaries; and it was usual for the appointee to be interviewed by the Government Actuary on first appointment. The appointed actuary's role was, in essence, to advise the company's Board on actuarial matters, including the financial well-being of the company and, in particular, to be satisfied as to the solvency of the company at all times and that the reasonable expectations of policyholders (see paragraph 33) could be met. The appointed actuary had to advise the Board of any points of potential concern that might arise, and how they might be addressed; s/he also had a duty to advise them as to the interpretation of policyholders' reasonable expectations in relation to the company's own policies. Legislation required that the appointed actuary had to make an annual investigation of the company's financial condition. The report, which would normally be presented to the Board, had also to be included in abstract in the company's regulatory returns. Failure by an appointed actuary to comply with the profession's practice standards (such as one set out in the Faculty and Institute of Actuaries' Guidance Notes) could lead to disciplinary action by the profession. In evidence to the Treasury Select Committee, the Faculty and Institute of Actuaries said that the appointed actuary system was regarded as providing a more effective degree of monitoring of a company's financial situation than could realistically be expected of the regulator.

28. Regulations 24, 64 and 65 of the 1994 Regulations (paragraph 22) permitted companies, for the purposes of meeting the regulatory solvency requirements, to anticipate the likelihood that profits on investments would arise in future and be available to meet future liabilities. This placed a value on their future profits, which was known as a **future profits implicit item** and could be regarded as an (intangible) asset. However, such items could only be included in the calculation of assets for the purpose of covering the required minimum margin, provided that a section 68 order was first obtained (see paragraph 25). A future profits implicit item could take account only of profits - which in this context meant investment return - expected to arise on business that was already in place, and the maximum value of such an item could not exceed one half of the expected full amount of those profits. The Regulations provided that the level of future profits should be determined by multiplying the estimated annual profit by the average number of years - to a maximum of ten - remaining to run on policies. For this purpose, the estimated annual profit was to be taken as the average annual profit achieved over the preceding five years (this is known as **the retrospective calculation**). The appointed actuary also had to certify that the amount applied for was less than the present value of the profits actually expected to arise in the future on the in-force business (**the prospective calculation**). The appointed actuary was not required to state the assumptions used in the prospective calculation, or to provide the results of the calculation, although guidance issued in 1984 by DTI - which was still current at the time of the events subject to this investigation - said that appointed actuaries should use "*cautious assumptions … similar to those required for the minimum basis for calculating* ***mathematical reserves***". (Mathematical reserves are based on a mathematical calculation of the basic reserves required to meet all prospective liabilities, including additional measures of prudence which at a minimum satisfy those laid down in regulations.) The DTI guidance also said that any exceptional profits that might have accrued over the period in question had to be excluded from the calculation.

29. Reinsurance is a process by which a life insurance company can effectively transfer part of its risk under a contract to another company, thus enabling the first company to hedge large or unusual risks and reduce the effect of variations in claims from year to year. Under The Insurance Companies (Accounts and Statements) Regulations 1996 reinsurance can also sometimes be used to improve a company's disclosed statutory solvency position - this is often known as financial reinsurance. Under a financial reinsurance arrangement the reinsurer may be entitled to recover from any future surpluses any payment made under a financial reinsurance agreement, although that entitlement is subordinate to the contractually guaranteed rights of policyholders. Reinsurance recoveries, prudently valued, can be included as an asset in the annual returns but the obligation to repay the reinsurer does not need to be recognised as a liability in the returns as its payment is contingent on future surpluses emerging. The reinsurer takes the risk that surpluses do not emerge and hence claims do not get repaid. If a company obtains reinsurance from an overseas insurer not subject to UK regulatory requirements, a looser regime may apply to the sums reinsured; this is often referred to as 'regulatory arbitrage'.

30. Under Regulation 25 of the 1994 Regulations (paragraph 22) life insurance companies could reduce the calculated reserves for liabilities by an adjustment known as a **Zillmer adjustment.** That allows the initial expenses incurred by a company when writing new business to be spread over the lifetime of the policy in proportion to the premiums due. In this way the initial costs are offset against the future income arising from that policy. Zillmer adjustments are applied only to policies where regular premiums are payable.

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31. The 1994 Regulations also provided that funds raised from the issue of loan capital did not count toward a company's assets for the purpose of calculating the required minimum margin, because the value of the money received would be offset by a corresponding liability to repay the loan together with interest. However, the Regulations did provide that such funds could be counted if the obligation to repay the loan was subordinated to the rights of policyholders and a section 68 order was obtained.

Prudential regulator's powers of intervention

32. The prudential regulator's primary objective is the protection of policyholders and potential policyholders and to that end they may use a range of powers of intervention. Under section 11 of the 1982 Act first DTI, from January 1998 the Treasury, and from January 1999 FSA, had the power, either at the request of the company or on any of the specific grounds listed, to issue a direction withdrawing the company's authorisation to conduct new business. One of the grounds so listed was that the criteria of sound and prudent management were not, or had not (or might not have) been fulfilled. Before giving a direction to the company under section 11, the prudential regulator had to serve on the company a written notice stating that they were considering giving a direction and the grounds on which they were considering it. The company could then, within one month of that notice being served, make written (or if the company so requested, oral) representations to the prudential regulator. The prudential regulator was then required to take those representations into account before giving a direction. The company could at any time seek judicial review of the prudential regulator's actions. That would not, however, in itself prevent the regulator from taking action, unless an order of prohibition were obtained within the Judicial Review proceedings; a company could also obtain a court injunction. Under section 12A of the 1982 Act, which was inserted in 1994, the regulator could withdraw immediately a company's authorisation to accept new business for a period of up to two months while they considered representations from that company. (This power was essentially an expedited procedure for withdrawing authorisation under section 11 and could therefore only be used if grounds under section 11 existed and the regulator considered that the authorisation needed to be withdrawn as a matter of urgency.)

33. Section 37 of the 1982 Act provided that the prudential regulator could intervene (through using a range of powers set out in sections 38 to 45 of the Act - see paragraph 34) to protect "*policyholders or potential policyholders*" against a risk that a company might be unable to meet its liabilities, or to fulfil the reasonable expectations of policyholders or potential policyholders (see paragraph 14). While there was no statutory definition of the concept of **policyholders' reasonable expectations**, it was generally accepted within the actuarial profession and the insurance industry as extending beyond the expectation simply that contractual liabilities or other legal rights would be met. Most with-profits policies contain some element of discretionary annual and terminal bonuses, and it was seen as reasonable that holders of such policies should expect companies to behave fairly and responsibly in exercising their discretion to distribute them. For with-profits business, policyholders were entitled to expect that benefits would reflect the asset share, which was the actuarially adjusted accumulated value of premiums paid, less deductions for expenses, tax and other charges, plus allocations of business profits or losses, accumulated at the rate of investment return achieved (effectively the proportion of a fund attributed to each investor). The focus in the case of such policies would be the total benefit payable at maturity. Traditionally asset share (subject to a smoothing process, that is averaging out the peaks and troughs of short-term stock market movements) had been regarded as providing the starting point for determining what that benefit should be. Guidance published by DTI in a Ministerial statement in February 1995, in the context of attributing surpluses in with-profits funds, said that policyholders' reasonable expectations would be influenced by a range of factors, notably: fair treatment of policyholders vis-à-vis shareholders; any statements of a company's bonus philosophy; a company's history and past practice; and general practice within the industry. According to a paper prepared for the FSA Board in January 1999, DTI had also received legal advice from Treasury Counsel, in respect of a scheme unrelated to these events which involved a policyholder vote, that the Secretary of State could not abdicate her responsibility for protecting the reasonable expectations of policyholders by simply leaving the issue for policyholders to decide. The regulators had to make their own decision as to whether proposed payments would meet the reasonable expectations of policyholders.

34. Section 43 of the 1982 Act enabled the prudential regulator to require a company to submit regulatory returns earlier than the date specified in the Act, at a date no earlier than three months before the end of the specified period. Section 45 of the 1982 Act enabled the prudential regulator to require a company to take such action as appeared appropriate "*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*". (This was effectively a reserve power to be exercised only where FSA considered that the above purpose could not be appropriately achieved by exercise of its more specific powers, as cited above, or by the exercise of those alone.) Because the exercise of intervention powers might bring about consequences which the regulator would otherwise want to avoid, including the possibility of adverse consequences for policyholders, regulatory judgment has to be exercised in deciding whether or not to intervene.

Regulatory approach

35. When FSA was established in 1998, nine regulatory regimes were brought together. The regimes for the prudential regulation of life insurance had not previously been as intrusive or as heavily resourced as some of the other regulatory regimes. The style adopted by the prudential regulators was variously described by

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them to my staff at interview as "*passive*", "*light touch*" and "*like negative vetting*", meaning that, while no regulatory intervention would be taken against a company unless a regulatory rule had been broken, informal pressure would be brought to bear. The philosophy of the regime, in contrast to those that had applied in some of the other financial sector regulatory regimes, such as banking, which concentrated on product and tariff control, was to allow consumers to benefit from competition between insurers through the downward pressure on prices and greater choice of products. The aim was to promote competition by combining maximum freedom for regulated companies within the rules, including the right to decide the nature of their policies and premium rates, coupled with full disclosure by them of relevant information. This approach was generally characterised as "*freedom with disclosure*".

36. In June 1999 FSA introduced lead supervision arrangements as a first step towards becoming a single integrated regulator. Lead supervision was intended to improve the effectiveness of FSA's supervision of groups or firms with more than one authorisation. The three key responsibilities of the lead supervisor were to prepare an overall assessment, to establish a co-ordinated supervisory programme, and to be the central point of contact. The lead supervisor's role was to understand and evaluate the group's business strategy, management capabilities and policies, systems and controls, resourcing and economic environment, and to prepare a risk-based plan of supervision over a specified period. The lead and other supervisors would normally agree the plan annually at a regulatory college meeting. The lead supervisor would ensure that information passed to him or her was disseminated properly and quickly within FSA.

37. Senior officials from the Treasury, FSA and the Bank of England meet monthly as the Standing Committee on Financial Stability, also known as the Tripartite Standing Committee. The Committee may also meet at other times when there is considered to be an urgent threat to the stability of the UK financial services industry.

Other enquiries into these matters

38. In December 2000 the Faculty and Institute of Actuaries announced that they were setting up an Independent Committee of Inquiry led by Mr Roger Corley to look into the events surrounding the closure of Equitable to new business and its implications for the profession in terms of the adequacy of professional guidance and the implications for the role of the actuary. The **Corley report**, which made a series of recommendations designed to improve and strengthen actuarial guidance, was published in September 2001.

39. Meanwhile, on 31 August 2001 the Government had announced that it would set up an independent inquiry, chaired by Lord Penrose (the **Penrose Inquiry**). The terms of reference of the Penrose Inquiry are:

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

Lord Penrose has announced that he aims to report to Treasury Ministers by summer 2003.

40. On 16 October 2001 FSA's report of the findings of their own internal review was published as a House of Commons paper (HC244). I shall refer to this as the **Baird Report**. The review was led by Mr R Baird, FSA's then Head of Internal Audit, and considered their regulation of Equitable from 1 January 1999 to 8 December 2000. The terms of reference of the review were set by FSA's Board and included: providing an independent account of events with professional support; FSA's discharge of functions contracted out by the Treasury; PIA's discharge of their functions; describing the background and events leading up to FSA assuming responsibility for prudential regulation of Equitable; describing the course of supervisory work from then until Equitable's closure to new business on 8 December 2000; and identifying any lessons to be learned. The Treasury submitted the Baird Report as evidence to the Penrose Inquiry. A summary of the report's recommendations and FSA's response to them is at Appendix B. As the Baird Report identified some apparent shortcomings on the part of the prudential regulators during that period, my predecessor decided to launch an investigation into the discharge by FSA (on behalf of the Treasury) of their prudential regulatory functions with respect to Equitable. I have regarded the complaint by Mr P, a long standing Equitable policyholder, who purchased an Equitable annuity in June 2000, as representing all the hundreds of others of investors who have complained to me about the prudential regulation of Equitable. The investigation has, however, been limited to the period covered by the Baird Report.

My investigation

41. After the investigation began in December 2001, my staff obtained papers from the Treasury almost immediately and - after some delay while consideration by all parties was given to certain legal issues raised by the third European Directive on life insurance - from FSA. The contents of the papers seen are summarised in the chronology of events at Appendix C to this report. My staff interviewed several past and present FSA staff members, a then member of GAD, and past and present members of Treasury staff (and a summary of that evidence is included in this report). I have also had the benefit of the advice of a specialist in actuarial matters, who was recommended to me by the Faculty and Institute of Actuaries.

Background to the complaint

Equitable

42. Equitable are the world's oldest mutual life assurance society. (In a mutual society like Equitable, the with-profits policyholders are also the society's members.) I understand that they were noted for the success of their

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sales force and the quality of their client base; they were also reputed to have advanced administration systems. Equitable had chosen to remain a mutual society and had a well-articulated and widely publicised policy of not holding back reserves, but allowing policyholders to follow the fortunes of the company. The Corley report (see paragraph 38) commented that Equitable were unusual, if not unique, amongst mutuals in not maintaining a free reserve or 'estate'. A notable feature of Equitable's portfolio of liabilities was the very high proportion represented by a single product range: the individual and group personal pension plans containing guaranteed annuity rate (GAR) options. The Corley report commented that "... *[no] other UK life insurance companies granted to policyholders quite such advantageous terms ...*". The lack of shareholders as a possible source of additional capital and the absence of any estate meant that, although sound, Equitable were - by design - not particularly strong financially. All of this information was in the public domain from Equitable's own information to policyholders, official returns and analyses published by commentators.

43. In 1957 Equitable began to introduce GARs on some with-profits policies, for many years offering a (flat rate) GAR of 4%. By 1975 this had increased to 7%, where it remained until Equitable ceased to offer GARs in June 1988. Although other companies also offered policies with GARs, Equitable were unusual in both the proportion of eligible policyholders (some 25% by value) and the generosity of the GARs offered. However, there were somewhat restrictive terms in many policies associated with the GAR option, for example in Equitable's case they could be taken only on a single life, not on joint lives, which many policyholders would be likely to view unfavourably. Equitable's GAR policies also offered greater flexibility as to retirement dates than did those of many of their competitors. No additional premium was charged for the GAR options, and Equitable did not set aside or reserve identifiable funds to provide for their maturity. The GARs were initially generally well below then current annuity rates. However, with the decline in interest rates in the 1990s, current annuity rates first fell below Equitable's 7% guaranteed rate in October 1993 and, in December 1993, Equitable introduced differential terminal bonuses to reduce the advantage the GAR would otherwise have conferred over policyholders who did not have a GAR option. Equitable believed that if they did not take such action, GAR policyholders would obtain more than their fair share of the relevant assets at the expense of those whose policies did not contain GARs. (A table at Appendix D demonstrates the increasing value of GARs to Equitable policyholders in the 1990s.)

44. Interest rates continued to fall, so that by mid-1995 Equitable's GAR rates consistently exceeded current annuity rates; (by mid-1997 this was true for most companies that had issued GAR policies). By September 1998, as general interest rates declined and began to fall significantly below the level of the guarantee, the value of the GARs for many Equitable policies had reached 30% above then current rates. Actuaries were also, as part of their regular reviews, further lightening mortality assumptions (that is, allowing for pensioners to live for longer than they had previously assumed). This had the effect of making Equitable's GAR options (where exercised) even more onerous, since they would need to pay the policyholder a larger annuity for longer than they had previously expected. (The GARs would have been calculated on the mortality assumptions prevailing at the point of calculation.)

45. In addition to GARs, there was a contractual yearly increase guarantee written into most of Equitable's relevant contracts of not less that 3$^{1}/_{2}$% each year irrespective of Equitable's investment performance. This was offset against any bonus declared for those policyholders (for example, the 5% bonus declared for 1998 was effectively a 1$^{1}/_{2}$% bonus for these policyholders, net of the 3$^{1}/_{2}$% guarantee).

46. There was no statutory requirement placed on insurance companies to include GAR liabilities explicitly in the regulatory returns unless they were regarded as having a value attached to them although appointed actuaries were required to have regard to the existence of options when calculating their liabilities and setting reserves. That effectively meant that until interest rates fell below the level of the guarantee, GAR liabilities were not necessarily captured in the returns.

Summary of events

47. For the sake of clarity I give the following summary of the events, described more fully in Appendix C. Although my investigation is limited to the actions of FSA as prudential regulator from 1 January 1999 onwards, the events leading up to that date provide essential background to what transpired in the relevant period. They are therefore included in some detail in Appendix C and this summary.

Events before 1 January 1999

48. Equitable first started selling policies with GAR options in 1957, and they ceased to offer them from June 1988. From 1994 onwards Equitable began to apply for - and be granted - section 68 orders permitting a proportion of future profits to be included as an implicit item in calculating their solvency margin (see paragraph 25). The first two orders, for years 1994 and 1995, were for £500m; these increased to £600m and £700m for 1996 and 1997 respectively. (The amounts actually used in the accounts increased from £250m to £371m in that period.)

49. In 1997 GAD gave Equitable's 1996 regulatory returns a priority rating of three (see paragraph 19) (up from four the previous year). In their scrutiny report, issued in December 1997, they commented that Equitable seemed vulnerable to any sustained stockmarket
downturn because guaranteed bonuses included credit for asset appreciation. They concluded that, while Equitable had no immediate problems with meeting their regulatory financial requirements, it would be desirable for them to reduce their guaranteed bonus levels. In January 1998 GAD told Equitable that it might be necessary for them to hold reserves for anticipated final bonus additions. However, when GAD finally closed scrutiny of the 1996 returns in June

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1998, they told the then prudential regulator that strengthening Equitable's reserves was unnecessary.

50. Meanwhile, since early 1997, the Faculty and Institute of Actuaries had turned their attention to the GAR issue (the fact that GAR rates were then generally exceeding annuity rates and therefore appearing in returns on a significant scale), and had set up a working party to review the matter and companies' practices. In late 1997 the working party reported that they were unable to recommend a single approach to reserving for GARs. They suggested however that adjusting terminal bonuses in response to guarantees (Equitable's approach) could be regarded as "*unsound*", because no explicit provision was being made for an explicit guarantee. In June 1998 GAD surveyed the approaches of life companies to reserving for GAR options. They found that seven other companies, from a cohort of 74, caused them serious concerns in terms of their reserving but that Equitable and one other company were notable exceptions to industry practice and were of particular concern in not holding substantial reserves to cover GAR liabilities and having only limited scope to raise funds to cover the liability.

51. In August 1998 GAD alerted the Treasury's insurance division to the increasing value of GARs resulting from lower interest rates and lighter mortality. They said that GARs were a significant problem in the industry both in terms of numbers and the threat they posed to solvency (i.e. meeting their regulatory financial requirements) and to policyholders' reasonable expectations. However, provided the contract allowed it, the terminal bonus could be restricted to keep down the cost of a GAR option (i.e. a differential terminal bonus could be used), but that would not justify lower reserving as the terminal bonus itself was not reserved for. In September 1998 GAD told the Treasury's insurance division that all companies should be asked to report on the procedures in place to ensure that guarantees were included in quotations, and that they should use complaints to trigger review visits. They added that a more proactive course of reviewing companies routinely would be too resource intensive to be practical, arguably a significant overreaction to the issue and open to criticism as a misuse of powers. Two weeks later they forwarded to the Treasury Equitable's survey reply, suggesting that they should explore the GAR issue further with them.

52. Over the subsequent months there was considerable debate amongst the Treasury, GAD and Equitable, both over whether Equitable's approach of providing differential terminal bonuses was acceptable practice, and over the reserves required in respect of GARs to maintain regulatory solvency. On the matter of the differential terminal bonuses, Equitable strongly maintained that their approach was fair to all their policyholders and produced a Counsel's opinion which confirmed that Equitable's actions were "*justified in law*" given the discretion provided to directors by the Society's articles and the policies with its members. GAD suggested to the Treasury's insurance division that there appeared to be some confusion within the industry over what was acceptable practice for charging policyholders for GAR options, and they needed to provide companies with guidance on their interpretation of policyholders' reasonable expectations (see paragraph 33) in respect of GAR policies. At the same time the Economic Secretary to the Treasury asked for information about Equitable's approach, as she had started to receive complaints about their differential terminal bonus policy. After further internal debate on the matter, when the Economic Secretary initially took the view that the complaints she had received were not without some merit, she eventually approved the guidance and the Treasury's insurance division issued it on 18 December 1998. The guidance said that, subject to any decision by the courts, GAR policyholders could expect to pay some premium towards the cost, perhaps by some reduction in the terminal bonus due on maturity [which was Equitable's practice]. What was acceptable in individual circumstances, however, would be dependent on the proper interpretation of contracts issued by individual companies. The guidance placed the onus on the management of each company to ensure that their policy was compatible with the terms of their contracts and their policyholders' reasonable expectations, that is, what they had been led to believe through representations made to them at the time the policies were sold and subsequently.

53. The reserving issue caused even greater debate throughout the same period. GAD referred Equitable to the outcome of the actuarial profession's working party (see paragraph 50) and insisted that it was a statutory requirement to reserve for what was potentially payable under the contract. Accordingly the company's reserves needed to reflect the full value (100%) of the GAR options available to policyholders (on the basis that policyholders could be expected to select the alternative cash option only while its value was maintained close to the value of the GAR). Equitable proposed to GAD that they should assume a GAR take-up rate of 25-35% in their reserving calculations. GAD warned Equitable that, if the company were unable to comply with the reserving requirement, regulatory intervention might result. Equitable, for their part, complained that their policy of adjusting the final bonuses of those taking a GAR option had been declared in their regulatory returns since those for 1993 and that, by failing to raise the issue earlier, GAD had tacitly accepted their approach for several years. However, under pressure from the Treasury's insurance division and GAD, Equitable subsequently agreed to revisit the need to reserve for GARs and to reassess solvency, but they objected that that could have severe consequences for them. They also agreed to consider reducing bonus declarations, but argued that cutting those drastically, as the regulator was urging them to do, was impractical without serious implications for public relations. They strongly contended that, if they gave way to regulatory pressure to adopt what they described as a "*wildly prudent*" reserving approach, which bore no resemblance to commercial reality and which was damaging to policyholders, that would have potentially very serious consequences. On being told that there was no appeal other than by way of judicial review, Equitable said that they might well have to take that option. (During that period Equitable also revealed that many GAR

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policyholders were entitled to pay further premiums to top-up their policies; this effectively meant that, although Equitable could make a reasonably prudent estimate of liabilities which could arise as a result of the payment of further premiums, they were unable to assess their full potential GAR liabilities with any degree of precision. Equitable said that they did not see this as a risk because of their differential terminal bonus policy.)

54. In November 1998 GAD reported to the Treasury's insurance division the overall results of their survey (see paragraph 50). They said that, while most schemes were 'in the money', some were not, and Equitable seemed particularly vulnerable. There was an unrecognised liability of some £3bn across the industry at the end of 1997, around half of which related to Equitable, who could be technically insolvent (i.e. unable to meet their regulatory financial requirements). However, an internal Treasury report the same month concluded that, if all policyholders exercised the GARs, Equitable would still just cover the required minimum margin (see paragraph 22); but that publication of such a low solvency position was likely severely to undermine their reputation and could threaten their independent survival.

55. In the meantime, Equitable continued to insist that they had a strong basis on which to resist GAD's position on reserving as excessively prudent, and the Treasury considered what action they could take if Equitable refused to accept the need to reserve in full for the GARs. Treasury's legal advisers said regulation 64 of the 1994 Regulations (see paragraph 23) was extremely wide and that it was for the courts, not the Treasury, to decide if liabilities had been properly determined. There was room for more than one reasonable view of proper provision and prudent assumptions. Further, the onus would probably be on the Treasury to show a breach, rather than on Equitable to demonstrate compliance. That said, if Equitable refused to accept GAD's view on reserving levels, the Treasury could pursue them using their powers under section 45 of the 1982 Act (see paragraph 34) on the grounds that Equitable were not meeting the requirements of sound and prudent management. Such intervention was unlikely to be successfully challenged in the courts.

56. The Treasury made it clear to Equitable that they were not prepared to change their position on the required reserving levels and certainly would not be inclined simply to make a section 68 order sufficient for Equitable to be able to counter Regulation 64. They agreed, however, to reconsider whether Equitable would meet the reserving requirement were they to enter into a reinsurance agreement (against a higher than expected GAR take-up), but, in line with standard practice, would accept such an agreement as having been effective from the year end only if Equitable could demonstrate that the broad terms of the agreement were in place and a firm intention to enter into an agreement had been shown before then. GAD reconfirmed to the Treasury their view that under Regulation 64 Equitable had no choice but to reserve in full for 100 per cent of the benefits available in GAR form. They said that if Equitable did so, they would just have sufficient cover for their required minimum margin as at 30 October 1998. It was therefore difficult to see how Equitable could justify declaring any bonus at the year-end. GAD also subsequently recommended to the Treasury that they should seek some commitment from Equitable to reduce the declared reversionary bonus until full provision for the GAR liabilities had been made.

57. In mid-December 1998, in preparation for handing over prudential regulation to FSA from 1 January 1999, the Treasury's insurance division briefed FSA senior management on their views on Equitable's position. They said that, if Equitable reserved fully for GAR options, their free assets (of £220m) were insufficient for them to declare a bonus that year. The Treasury said that they were not minded to take action against Equitable for failing to reserve fully in the 1997 returns, but would intervene if the 1998 returns did not comply. They would also intervene (by closing the company to new business) if Equitable either declared a further bonus without prior discussion with them, or declared a bonus which would breach the required minimum margin (see paragraph 22). If GAR options were fully reserved without the reinsurance agreement in place, Equitable would be close to breaching the required minimum margin. On 22 December Equitable applied for a section 68 order for a future profits implicit item of £1.9bn to be counted as part of their solvency margin on 31 December 1998, and they subsequently forwarded details of a proposed reinsurance agreement, which had been discussed with the Treasury on 3 December. The Treasury granted the section 68 order on 31 December; the following day operational responsibility for prudential regulation passed to FSA.

Events from 1 January 1999 onwards

58. On 4 January GAD told FSA's prudential division that they were seeking further information from Equitable in the light of which they would consider phasing in the higher reserving requirement (Equitable would require a £1.5bn reserve to cover GARs in full). On 13 January the Government Actuary issued guidance to all appointed actuaries reminding them of the need to make proper provision for GAR liabilities on prudent assumptions. On 15 January in response to complaints from their policyholders about the legitimacy of their differential terminal bonus policy relating to GAR policies, Equitable funded an action by a representative GAR policyholder, Mr Hyman, to put before the court the arguments against their differential bonus policy.

59. On 18 January the prudential division asked Equitable for more information about their reserves, assets and financial condition. On 21 January Equitable told the prudential division that they planned to declare a 5% annual reversionary bonus (down from 6.5% for 1997). They said that they had entered into a financial reinsurance arrangement with effect from 31 December 1998 at a cost of £150,000 per annum which would provide support to Equitable when more than 25% by value of the GAR business maturing in that year selected the GAR option. The next day FSA's prudential division recorded that Equitable were one of four companies giving cause for concern, and that it was questionable whether

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they would be able to declare a bonus that year. Based on the GAD estimate, Equitable were only just covering the required minimum margin at end-October 1998 without reinsurance, with £1.15bn available assets to cover a regulatory solvency margin of just under £1bn. Should the court case go against them, their position could become even more precarious (because the reinsurance could lapse in that event).

60. On 26 January Equitable provided the information the prudential division had requested on 18 January; the prudential division responded by asking for further information including sight of any bonus recommendations made to the Board in the previous 12 months. The same day the prudential division decided that they preferred not to continue earlier efforts to reach a view on policyholders' reasonable expectations until after the conclusion of the court case as, although it would not preclude FSA from taking a view on whether Equitable's policy was consistent with policyholders' reasonable expectations and the possible need for intervention, the court's judgment on whether or not those expectations had been met would be sure to influence FSA's view.

61. On 27 January GAD raised a number of concerns with the prudential division about the reinsurance arrangements, including the fact that the draft reinsurance agreement could be cancelled retroactively if Equitable changed their practice on GAR options (which GAD presumed included Equitable losing their court case). Those concerns prompted a meeting between Equitable, GAD and the prudential division the next day to discuss the matter, which resulted in Equitable being asked to seek various revisions from the reinsurer. On 29 January GAD commented on the Board papers Equitable had forwarded relating to their proposed bonus declaration. GAD said that, while the financial position shown was likely to appear reasonably satisfactory, Equitable would be potentially close to regulatory action for failure to maintain the required minimum margin if the reinsurance were not completed satisfactorily. While, therefore, it would be difficult for FSA to object formally to what Equitable were proposing, they would need to monitor Equitable's position carefully. GAD commented that both they and FSA should voice their concerns to Equitable about their vulnerability and ask them to produce some contingency plans to show how they would react to adverse investment conditions. GAD also pointed out that Equitable continued to issue annual notices to policyholders showing a high level of projected benefits and thereby generating further expectations.

62. The prudential division immediately wrote to Equitable (on 1 February) on the lines suggested by GAD, underlining the fact that, in the absence of a robust reinsurance agreement, it would not be prudent to declare any bonus for 1998. They concluded, however, that were the reinsurance agreement to be revised to resolve GAD's concerns, they were not minded to object to the proposed bonus declaration. Two weeks later Equitable sent the prudential division a copy of the revised draft reinsurance terms, which led to both the prudential division and GAD raising further matters on it. On 22 February GAD confirmed to Equitable that they would accept the principle of the reinsurance offsetting GAR liabilities as set out in the terms of the agreement (paragraph 59), but added that they still needed to see the final version of the agreement.

63. On 24 February, however, FSA's prudential division raised with Equitable concerns of a different nature, namely that their 1997 regulatory returns might have given potential policyholders a misleading impression about Equitable's financial position. Equitable were asked to agree by 3 March to submit the 1998 returns by 31 March 1999 or face possible regulatory action. (FSA took the same action in respect of several other life assurance companies who had sold GAR policies.)

64. Equitable were not specifically mentioned at the first quarterly meeting between the Treasury and FSA's prudential division on 10 March. The following week, the relevant FSA managing director told the FSA Board about Equitable's particular difficulties. On 19 March the prudential division summarised the position of the six companies identified as being potentially at risk from GAR options and whose statutory solvency could be threatened if economic conditions were to deteriorate. Of those six, Equitable were viewed as giving rise to the greatest concern as their financial position had been very severely affected. The prudential division said that, despite action taken to restore Equitable's solvency margin to a more acceptable level, they remained concerned about the viability of Equitable in the longer term, and they set out their particular concerns. They concluded that the position would worsen if Equitable lost the court case.

65. Equitable submitted their 1998 regulatory returns on 30 March as requested. The same day they applied for a section 68 order to allow a future profits implicit item of £1bn to be used towards their required solvency margin on 31 December 1999 (they had included a future profits implicit item of £850m in their 1998 returns). On 9 April GAD reported to FSA the results of their initial scrutiny of Equitable's 1998 returns, saying that the financial position appeared satisfactory, but they had not yet seen a copy of the finalised reinsurance agreement and they asked the prudential division to request it urgently, which the prudential division did.

66. On 20 April Equitable told the prudential division that the reinsurance agreement had not yet been completed, and they sent a copy of the terms sheet which would form its basis. That showed that the reinsurance agreement remained contingent on no change being made to Equitable's then current GAR bonus practice, either by choice or as a result of legal action; and that if the withheld claims balance exceeded £100m, negotiations would take place to find a mutually acceptable restructuring of the agreement. Equitable also enclosed a copy of a paper prepared for their Board on measures to protect their statutory solvency position. One issue that the paper discussed, but could offer no solution to, was how Equitable might use policy conditions to restrict the growth in GAR business. The paper concluded with a list of measures which it was said would seem sensible to

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pursue. Commenting subsequently on those measures, GAD said that they seemed "*fairly plausible*" but could ultimately reduce investment returns. They were also content with the level to which any future repayment premiums under the reinsurance agreement had been subordinated to policyholders' rights.

67. On 4 May Equitable provided the projected solvency information which FSA had requested on 1 February (see paragraph 62). This showed three different scenarios, each making different assumptions as to developments in the investment markets. All three showed Equitable remaining solvent and the position improving steadily. They had attempted to project the impact of losing the court case, although they said that was difficult to do as there were a number of varying components. In their view, however, the key solvency consideration of an unfavourable outcome was replacement or modification of the reinsurance arrangement, which was being actively pursued.

68. On 20 May GAD provided FSA's prudential division with a scrutiny report on Equitable's 1997 and 1998 regulatory returns; this gave Equitable a priority rating of 2 (up from 3 for the 1996 returns - see paragraph 49). They highlighted a number of problem areas but concluded that, because of the way they operated, Equitable should be able to work their way out of their solvency margin problems. They needed however to hold back more emerging surplus by declaring lower guaranteed bonuses; and to give policyholders greater warning about the possible implications for bonuses of a substantial market setback. The following day GAD suggested to FSA that Equitable should be asked to consider further possible scenarios and to confirm the basis of some of their calculations. Meanwhile, Equitable had written to the then Economic Secretary complaining about the level to which they were being required to reserve for GARs; she replied on 14 June.

69. In the meantime both the prudential division and Equitable had been considering the possible outcome scenarios to Equitable's court case and the resulting implications. On 21 June Equitable told the prudential division that their lawyers had identified six possible scenarios, but that they considered all of them except for two, namely complete success, or success but with some adverse comment to be highly unlikely. Nevertheless, Equitable had been discussing with the reinsurer possible amendments to the reinsurance agreement, and discussing other possible arrangements with other reinsurers. The next day the prudential division reviewed Equitable's court papers and commented that they made no mention of policyholders' reasonable expectations. On 24 June FSA's prudential division asked their conduct of business division if they had any jurisdiction over the bonus notices issued to policyholders, and whether they could require Equitable to change them. They sent the conduct of business division copies of the 1996 and 1997 notices, which they said they thought were possibly misleading, and said that they would forward the 1998 notice the following week.

70. On 25 June, prompted by concerns expressed by GAD on the likely consequences if the court referred the issue of policyholders' reasonable expectations to FSA, the prudential division prepared a paper on action FSA might need to take if the court did not give a clear view on how policyholders' reasonable expectations might be viewed. They said that they saw no point in reaching a view ahead of the court judgment, but that they would do some more work on it so as to be ready to give a view shortly afterwards. They added that Equitable's bonus notices, which seemed to give policyholders unrealistically high expectations of the pay-outs they could expect, were currently the main evidence in support of the argument that Equitable's approach was not consistent with policyholders' reasonable expectations. They had raised that matter with Equitable previously, but they had not as yet made any progress in obtaining changes.

71. On 29 June Equitable met GAD and FSA's prudential division to discuss further information they had provided, and the court case. Equitable said that their lawyers considered it very likely they would win the court action but with some adverse comment, but considered the worst case scenario (whereby bonus rates for both the cash fund option and annuities had to be equalised at the highest cash level) as inconceivable. The prudential division pointed out that, even if Equitable won, FSA would still need to consider whether their bonus policy met policyholders' reasonable expectations; they said that they had concerns about information contained in bonus notices, but had not yet reached a view on that. Equitable insisted that their practice of paying out as much as possible in bonuses and not building up any hidden estate offered best value to policyholders, as well as being a useful deterrent against predators. Equitable said that they had been approached by a number of suitors, but the reply had been that they were committed to mutuality.

72. The court hearing began on 5 July and the same day the prudential division sent FSA's managing director and the conduct of business division a note about the legal action and the implications both for Equitable and FSA in terms of follow-up action required. They set out the implications of three possible outcomes: Equitable winning, winning in part, and losing the case. In the last case the reinsurance would then be invalid, although Equitable had established that there was scope for replacing it; should that not be possible Equitable would only just cover the required minimum solvency margin after taking full account of future profit implicit items. Equitable would need to consider drastic measures which might precipitate a take-over bid or a reduction in business. The prudential division would need to determine the company's solvency position and, if the required minimum margin was breached, to require a plan for the restoration of a sound financial position. Even if the solvency margin were not breached, the prudential division would require steps to be taken to strengthen the position in the short to medium term. There would also be the question, if there were a significant risk that Equitable would be unable to meet their liabilities to policyholders, of whether to close the company to new business or suspend their authorisation.

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73. On 9 September the High Court ruled that Equitable were entitled to operate their differential terminal bonus policy, but the opponent was given leave to appeal. GAD told FSA that they could see nothing in the judgment which was inconsistent with the guidance they had issued on the subject, although FSA might need to consider intervening in respect of those policyholders whose expectations might not have been met. FSA's legal division also pointed out various issues arising for FSA relating to policyholders' reasonable expectations, but noted that the prudential division had decided to defer a decision on taking action until the appeal had been concluded. On 15 September the prudential director suggested to the conduct of business director that they needed to consider the matter from the perspective of all the FSA constituent bodies but should not decide on any action until the appeal court's decision was known. If the judgment were overturned it was possible that action would be warranted under the 1982 Act, and he wanted to avoid any action which might constrain or prejudice such action. They would consider the matter further in the light of an analysis that they had agreed should be undertaken while the appeal was pending.

74. On 23 September the conduct of business division responsible for regulating PIA member firms wrote to their prudential colleagues about the Equitable bonus notices which they had referred to them (see paragraph 69). The conduct of business division said they did not consider Equitable's bonus notice to be poorly presented or inaccurate and did not therefore intend to take action under the 1986 Act and the PIA Rules. They went on to say that historically they had not regarded post-sales literature as within their remit and would therefore have to have serious concerns about a document before taking action against a company.

75. The next day GAD advised that Equitable's application of 30 March 1999 for a future profits implicit item of £1bn could be accepted by FSA. They confirmed that the calculations provided were in line with the guidance and that the sum applied for was only about one third of the sum for which they could have applied, and was substantially less than they had been allowed in 1998. However, Equitable should first be asked for certain confirmations and for a copy of the reinsurance agreement as finally signed (which Equitable subsequently provided and GAD accordingly confirmed as acceptable). The prudential division accordingly recommended to the Insurance Supervisory Committee (see paragraph 18) that the application be granted. They told the Committee that, while there was some debate at the margins between Equitable and GAD about the reserve for GAR options, the prudential division were generally satisfied that Equitable were adequately reserved for their exposure to GAR options, which had "*been largely offset*" through reinsurance. The Committee approved the application and the Treasury issued the order on 9 November.

76. On 17 November the prudential division prepared a risk assessment of Equitable as part of piloting a new approach to company assessment. This suggested that Equitable should be seen as a high financial risk for a number of reasons which they detailed. The assessment said that, while Equitable had not been alone in being caught out by the GAR issue, they had not woken up to it quickly enough, and communication to policyholders of their change in policy in relation to bonuses was decidedly unclear and left Equitable open to criticism. The overall assessment prepared as part of the regulators' co-ordinated supervisory programme (see paragraph 36) confirmed Equitable as medium to high risk.

77. On 21 January 2000 the Court of Appeal gave judgment against Equitable by a majority of two to one. One of the majority judges, however, went on to say at the end of his judgment (in a comment that did not form part of his reasoned decision) that it was legitimate in his view for Equitable effectively to ring-fence funds relating to different types of policyholder, which could result in those policyholders with GARs not doing much better in cash terms. Equitable were granted leave to appeal to the House of Lords and were permitted by the court in the interim to continue their differential terminal bonus policy pending the appeal on Equitable's assurance that if the Court of Appeal's decision was upheld, Equitable would pay additional sums in respect of any policy maturing after the Court of Appeal's judgment. GAD told the prudential division that the judgment meant that most of the advice in the guidance note issued by the Treasury on 18 December 1998 remained valid. They suggested that the extra costs to Equitable might be fairly marginal, but that Equitable should be asked to confirm that the judgment did not affect the reinsurance agreement. The prudential division told their conduct of business colleagues that the judgment gave no cause for panic. Although the publicity was likely to dent Equitable's sales, their reserving requirement would not be affected and so their regulatory financial position would be largely unaltered.

78. On 28 January the prudential division prepared a note setting out the implications for the insurance industry if the House of Lords were to uphold the Appeal Court's judgment. They said that, although Equitable would need to revise their bonus policy for future years, the new approach need not lead to any significant additional costs for them. The legal division circulated a summary of the judgment, commenting that each of the four judges who had at that stage considered the case [the High Court judge and the three Appeal Court judges] had arrived at their respective conclusions for different reasons. It was therefore not possible to predict the House of Lords' decision, and any attempt to do so, or to determine the implications of the Court of Appeal's judgment, would be of little benefit. Over the subsequent months discussions continued internally about the wider implications of the Equitable court judgment for policyholders' reasonable expectations more generally.

79. Meanwhile, on 1 February, Equitable had written to policyholders assuring them that there should be no significant costs for Equitable were the House of Lords to uphold the Court of Appeal's judgment. On 22 March Equitable published their Directors' report and accounts for 1999 and declared a bonus of 5%. The accounts stated that a prudent provision of £200m had been

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included for GAR options. The Directors' report made no specific mention of the legal action, but the parallel Annual Report did set out the background to the litigation and progress up to then (they said they expected the House of Lords' hearing to be in June and the judgment to follow shortly thereafter). At the end of June Equitable submitted their regulatory returns for 1999 and applied for a section 68 order for a future profits implicit item of £1.1bn for use in their 2000 accounts. On 7 July GAD recommended that the application be granted on the grounds that there was a significant margin between the sum applied for and the maximum for which Equitable could have applied (£3.3bn), and the appointed actuary had confirmed that he had taken account of the reinsurance agreement in determining the value of the future profits.

80. On 4 July FSA's relevant managing director told senior colleagues that one of Equitable's directors had approached him to say that there were "*straws in the wind*" that the Lords would find against Equitable. Equitable were considering "*what level of sacrifice*" might be needed at the top of the organisation. On 18 July Equitable met with FSA's prudential and legal divisions and GAD to discuss contingency planning for the House of Lords' judgment which was due on 20 July. They thought it unlikely that the House of Lords would find against Equitable, but discussed the possibility that Equitable might be prevented from altering the rate of bonus for policies containing GAR options. Whilst this had previously been identified as a possible [but not a probable] outcome, it was beginning to appear more likely in the light of the arguments put forward for the first time at the House of Lords' hearing. The cost of that outcome (referred to as the third option) would be in the region of £1bn to £1.5bn and would have a profound effect on Equitable's regulatory solvency. Equitable had not attempted to renegotiate the reinsurance agreement to take account of such a ruling and such renegotiation was unlikely to be viable. In the event of such a ruling, they would immediately announce their intention to seek a partner. Although Equitable did not believe that they would then be insolvent [in other words that they would breach their regulatory solvency requirements], they were keen to avoid precipitous regulatory action should the judgment go against them, mainly because that was likely to have a detrimental effect on the value of the business. The prudential division said that they would not rush to take remedial action in such circumstances, but would need to be convinced that a suitable buyer was likely to be found quickly. Equitable said that, if the House of Lords simply upheld the Court of Appeal judgment, they expected to reduce the bonuses payable to GAR policyholders as a class; they did not consider that that would contravene the judgment.

81. The following day (19 July) the prudential division prepared a note (effectively an update of earlier scenario planning) setting out the possible outcomes of the appeal, and the regulatory action that was likely to be appropriate in each case. The note recognised the third option (see paragraph 80) as a possibility, but much less likely than the other two potential outcomes. Should the third option become reality, Equitable would only just be able to meet their required minimum margin and would therefore seek a partner. It was expected that there would be no shortage of potential partners.

82. On 20 July the House of Lords' judgment held, both in terms of the GAR policies and Equitable's Articles of Association, that Equitable could not apply different rates of bonus depending on whether or not the policyholder took benefits based on GARs, and that they could not pay lower bonuses to GAR policyholders as a class (ring-fencing). Equitable immediately announced that they were seeking a buyer, and told the prudential division that they planned an immediate cut of 5% in the value of all with-profits policies on non-contractual termination and that no bonus would be allotted for the first seven months of 2000; they said that they expected bonus levels to be restored once a sale had been completed.

83. The next day the Treasury told FSA's prudential division that it was likely that they (Treasury) would be asked for a brief on the situation with Equitable. They said that the judgment prompted thoughts on the wider implications for the future development of the life insurance sector and the effectiveness of the regulator. They set out a number of key questions, including whether FSA ought to have done more and said that, while they did not want answers at that stage, FSA should consider those points and be ready to respond at short notice.

84. On 24 July the prudential division told GAD that, in their view, the House of Lords' judgment had no implications for the life insurance industry as a whole, because they had required companies to reserve fully for GAR options with the same level of reserve being required whether or not differential terminal bonuses were paid. The impact had been different for Equitable because the judgment had led to a reduction in assets, as it had rendered void the reinsurance agreement, rather than an increase in liabilities. GAD replied, confirming the prudential division's analysis. They said that, in retrospect, Equitable had acted imprudently in taking credit for the reinsurance. In an internal minute, the prudential division commented that while a sale could not be regarded as an absolute certainty, it had to be close to 99.9%. They also circulated an action plan under which FSA were to obtain confirmation as to Equitable's regulatory solvency and review projections of future solvency; review the 1998 guidance; ask other companies what implications they saw for themselves; and arrange discussions with Equitable about the bidding process.

85. On 26 July Equitable announced the changes to their bonus rates (see paragraph 82), but added that through the sale they would be looking to secure funds to make good the lost growth. The same day Equitable's appointed actuary wrote to the prudential division setting out the company's solvency position. He said that, while he accepted that the company's position would be unacceptably weak on a continuing basis, in view of the steps that they had taken to strengthen the position, Equitable should be regarded as meeting the required minimum margin.

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86. The same day the prudential division replied to the Treasury's questions (see paragraph 83). On the matter of whether the guidance the regulator had issued on meeting the cost of GARs had been right, they said that it would have been difficult for any guidance to be consistent with the full range of judgments that had appeared. If they had been wrong, then so too had the actuarial profession, since the Faculty and Institute of Actuaries had gone on record as saying that they fully supported the guidance. The prudential division said that they were not convinced that either the Treasury or FSA could or should have pushed Equitable to alter their bonus practice; that practice "*was not clearly unlawful*", as had been demonstrated by the first judgment and the fact that the Court of Appeal had found against them only by a majority.

87. On 11 August Equitable, the prudential division and GAD met to discuss the regulatory aspects of the sale process. On 24 August the prudential and conduct of business divisions met to discuss the House of Lords' judgment and its implications. The prudential division said that it was hoped that a buyer would be identified by December, and that the process could be completed by June 2001. The judgment was not considered to have regulatory solvency implications, but Equitable had experienced a weakening of their financial position because the reinsurance had been conditional upon their continuing to pay differential terminal bonuses, and so had been terminated following the judgment. The reinsurance agreement had been renegotiated, which had given the company "*a bit more breathing space*"; however, the solvency position "*remained tight*". As a result of that meeting, the conduct of business division concluded (see paragraph 120) that Equitable remained solvent and need not therefore be required to make specific disclosures to new policyholders.

88. On 1 September the appointed actuary submitted Equitable's solvency update to 31 July which showed excess assets of £1.3bn. The same day the prudential division recommended to the Insurance Supervisory Committee that they should grant Equitable's application for a future profits implicit item of £1.1bn. They said that, although Equitable had been weakened as a result of the House of Lords' judgment, they were still solvent. They were seeking only a third of the sum to which they were entitled, and the relevant calculation had been checked by GAD. As a result, on 11 September the chairman of the Insurance Supervisory Committee told members, by e-mail, that Equitable's section 68 application involved a "*fairly standard request*" for a concession for a future profits implicit item. The prudential division's recommendation made clear that Equitable's request was well within normal parameters, and he saw no difficulty in agreeing to the recommendation. He added, however, that the implicit item was an important aspect of Equitable's overall financial position and, given the company's high profile at the time, some members might wish to discuss the paper. One member responded with two detailed points on the practicalities of taking credit for the future profits implicit item. The Committee approved the application the same day without meeting and on 13 September the Treasury issued the section 68 order.

89. At their quarterly meeting with FSA the following week the Treasury pointed out that Equitable were still advertising for new business. FSA repeated that Equitable's difficulties did not affect their solvency, only their freedom to invest.

90. On 21 September the relevant managing director told the FSA Board that the House of Lords' judgment had gone much further than the previous court ruling in that it had said that Equitable could not 'ring-fence' GAR business from other with-profits business for the purpose of setting the terminal bonus. The extra costs of the GARs therefore had to be spread amongst all policyholders in the fund. This had potentially serious implications for the reasonable expectations of other with-profits policyholders. The next day GAD told the prudential division that they had no questions to raise about Equitable's regulatory solvency at that time, although they pointed out that without the future profits implicit item, Equitable would have excess assets of just £300m.

91. On 9 October the appointed actuary told the prudential division that as at 31 August Equitable had excess assets of £2.165bn. He said the huge change from the July position was due to the markets having strengthened in the interim. Meanwhile, since Equitable had announced in July that they were seeking a buyer (see paragraph 82) a large number of bidders had expressed an interest and had been assessing Equitable's financial position. A number of those had since withdrawn. In a report to the FSA Board on 19 October the managing director said that, despite difficulties in assessing the level of liability arising from the House of Lords' judgment, Equitable had received three serious offers to buy them, all of which were high enough to enable repayment of the bonuses withheld for the first seven months of the year, with an additional payment for goodwill. However, FSA would need to see the detailed bids and structure to determine whether the with-profits funds were strong enough to secure the desired restoration of investment freedom going forward. On 30 October Equitable's appointed actuary provided solvency figures which showed excess assets as £1.14 bn at the end of September.

92. On 31 October a potential bidder for Equitable, (whom I call bidder A) told FSA that they believed that the shortfall in Equitable's funds was greater than Equitable themselves had estimated. Bidder A expressed concern that the wording of Equitable's policies allowed GAR policyholders to increase their contributions to the fund, to which the guarantee would attach, thereby increasing the fund's liabilities to the detriment of other policyholders. They said that they were investigating whether and how that liability might be capped, but said that they were more pessimistic on the issue than were Equitable's directors. The same day at a meeting of FSA's Firms and Markets Committee, FSA's Chairman expressed concern over press reports that there was little interest in purchasing Equitable; he saw a risk of them reaching the position where only one bidder remained. For the moment, however, there were still three bidders and it was still thought likely a sale would be achieved.

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93. Meanwhile GAD had been considering possible ways by which Equitable might cap the liability arising from GAR policyholders making topping up payments, short of stopping Equitable from writing new business which, they said, would almost certainly end any chance of a sale. [Although GAR policyholders in fact had a contractual right to make top-up payments even after any closure to new business.] They noted however, following a meeting with Equitable and the prudential division on 3 November to assess Equitable's position, that Equitable did not appear to believe that the issue was a serious concern for potential bidders. GAD also recorded that the aggregate value of the recent cut in bonus rates amounted to £1.5bn, which was expected to be sufficient to cover the cost of paying GARs on full asset shares. That meant that new policyholders should not have to meet the cost of GARs, although they would be joining a very weak fund. GAD noted that if no sale were to take place Equitable would almost certainly have to stop writing new business, and very probably have to rearrange their investments to a more defensive position to protect against possible liquidation in the event of a substantial fall in equity values. In the light of further complaints from policyholders about the appropriateness of Equitable's advertising, the prudential division prepared a draft response to them, which they circulated to conduct of business colleagues. They said that, as Equitable remained solvent and continued to meet the statutory regulatory requirements, there was no reason to stop them from marketing their products, nor did their advertisement appear misleading.

94. On 6 November another potential bidder, bidder B, met with the prudential division and GAD and expressed significant concerns about the risks they would be taking on if they were to acquire Equitable; the reinsurance agreement; a Zillmer adjustment (see paragraph 30) included in Equitable's resilience reserve; and the possibility that, given Equitable's precarious regulatory solvency position, Equitable might "*go through a period of statutory insolvency*" before making a recovery. On 9 November bidder B told FSA's Chairman that, although they had been very interested in acquiring Equitable, they had reached the view that the financial position was considerably worse than they had first thought, and perhaps rather more doubtful than FSA had been led to believe. They expected soon to tell Equitable that they did not wish to proceed.

95. In an internal note dated 15 November the prudential division set out how each of the possible outcomes of the bidding might be handled. While noting the serious concerns raised by potential bidders about Equitable's exposure to certain liabilities, the prudential division concluded that there were still no grounds for considering action on the basis of regulatory insolvency, as Equitable were able to meet their contractual obligations. The same day bidder B told the prudential division that they considered it would not be worth taking Equitable "*at any price*". Some current policyholders were clearly expecting a restoration of bonuses foregone and perhaps even a demutualisation bonus, expectations which would be impossible to meet. The following day GAD commented that if no buyer were found, and Equitable intended to remain open to new business, FSA would have to require Equitable to commission an independent investigation into their viability. They said that Equitable were very close to not covering their required minimum margin for regulatory solvency. It would be difficult to arrange a rescue by another insurer should they become technically insolvent.

96. Over the next two weeks FSA's prudential division continued to explore with the potential bidders various issues including: the possibility of capping Equitable's liabilities; whether the acceptance of payments into non-GAR policies (which might then have to be used to subsidise GAR policy payments) might be viewed as mis-selling (the conduct of business division said not if an appropriate warning had been given); whether the proposals would meet policyholders' reasonable expectations; and whether a future profits implicit item could be transferred to the buyer. Equitable and GAD also continued to debate the determination of appropriate reserving levels. The appointed actuary reported Equitable's excess assets at the end of October as £1.08bn.

97. On 24 November GAD submitted their detailed scrutiny report on Equitable's 1999 regulatory returns. Although the solvency position appeared reasonable, with available assets of £3.861bn to cover a required minimum margin of £1.114bn, they noted that that figure included a future profits implicit item of £925m, disregarded liability to repay a subordinated loan (paragraph 31) of £346m, and benefited from a reduction in liability of almost £1.1bn resulting from the reinsurance agreement. Without those factors, the available assets would reduce to £1.511bn. The report went on to cite a list of further weaknesses in Equitable's position, and added that the question of whether Equitable should continue to sell non-GAR policies in a common fund with GAR policies could be considered an "*environment risk*".

98. On 29 November the prudential division told FSA's managing director and Chairman that two potential bidders [bidders A and C] remained. Equitable's preferred bidder [A] were to submit a recommendation to their Board on 7 December on whether to bid or not. At a meeting between Equitable, the prudential division and GAD on 1 December however, it was concluded that there now seemed to be only one realistic bidder remaining [bidder A] and it was doubtful that the sum they would offer would be sufficient to allow Equitable to proceed with the sale. Should that be the case, it was likely that the company would close to new business and sell the sales force and infrastructure. It was noted that there was still disagreement between GAD and Equitable on the reserving requirement and on the use of the Zillmer reduction. It was also noted that Equitable had not considered whether policyholders who had joined after the House of Lords gave judgment could be excessively disadvantaged in a closed fund, since from that date it had been known that preferential treatment would be given to GAR policyholders. Equitable's managing director confirmed that the sales force had been adequately

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briefed and instructed to advise potential policyholders of the company's circumstances. He said that Equitable had taken legal advice as to whether they should continue to write new business. That same day the prudential division met with the two remaining potential bidders [A and C] and it became apparent that they might both be about to pull out of the process.

99. Bidder C pulled out on 4 December after Equitable felt unable to agree to allow them a period of exclusive negotiation, and the same day bidder A told FSA that they were becoming increasingly concerned that acquisition of Equitable would be uneconomical. They said that they could not predict their Board's decision on 7 December. On 5 December FSA's prudential division told their managing director that GAD had made possible adjustments to the free asset estimates provided by Equitable to include various assumptions in the reserving basis which would bring them into line with what GAD would normally expect. If all the assumptions were correct and all the adjustments made, this would leave Equitable with free assets of only £70m [this was an arithmetical error; the correct sum was £20m - see Appendix C, entry for 1 December 2000] above the required minimum margin, some £1,010m less than Equitable's own estimate. If no bid were forthcoming, they believed that FSA would have grounds for closing Equitable to new business, either for failing to meet the required minimum margin or because of the risk that policyholders' reasonable expectations would not be met. However, they would prefer Equitable's directors to take that decision.

100. On 5 and 6 December urgent meetings were held (including internal FSA meetings, the FSA Chairman's Committee and with Equitable) to discuss the implications if the final bidder withdrew. An urgent meeting of the Tripartite Standing Committee (see paragraph 37) was called on 6 December to discuss whether the closure of Equitable would have any systemic consequences for financial stability. The Committee noted that closure to new business would be the only option if the sale fell through. They agreed that Equitable's position had been unique, which meant that the House of Lords' judgment had had a particularly significant effect on them. It was noted that Equitable could not refuse top-up payments from with-profits holders with guarantees, even though they would potentially harm non-GAR with-profits policyholders. FSA said that that was why, given Equitable's lack of substantial surpluses, they could no longer prudently write new business. Treasury officials also briefed the Economic Secretary that a sale was unlikely to take place; they said that this was mainly because it was impossible to cap Equitable's GAR liabilities. They said that, while it might be argued that the regulator should have stopped Equitable writing new business sooner, there had until a few days previously been every sign that a sale could be achieved. The regulators had been just as surprised as the markets that no buyer could be found. The briefing said "*Does this event show up a deep-seated oversight on the part of the regulator? Probably*" (in failing to ensure that proper risk management processes were in place at Equitable), but that oversight had not been life threatening until the Lords' judgment, the scope of which had been quite unexpected so far as the prudential division were concerned. On 7 December bidder A withdrew and the following day Equitable closed to new business. At a meeting of the FSA Firms and Markets Committee the next day the minutes show that it was queried whether proper disclosure about the firm's position had been made since the House of Lords' judgment. A committee member suggested that, if it had not, "*policyholders might be able to claim compensation for mis-selling. There might also be a need to consider disciplinary action*".

101. The next quarterly meeting between the Treasury and FSA took place on 13 December. According to a Treasury note of the meeting (which Treasury say was written some weeks after the discussion on the basis of a contemporary manuscript note), ring-fencing the GAR liability by buying out the options would have cost bidder A over £1bn and the company could not afford to do that in addition to the launch of stakeholder funding. The prudential division were reported as then saying that neither FSA nor Equitable had realised the extent of the GAR liability. Equitable had thought that the liability was capped and FSA had not appreciated the scale of the problem; FSA had said that the whole GAR experience had been a "*wake-up call*" for them and for the industry to review their structure and their strategies. The prudential division had reported that the House of Lords' judgment had been completely unexpected. Regarding allegations that had been made of mis-selling after the House of Lords' judgment, the prudential division said that, although a script provided to Equitable's sales force by the company had not dealt with the problems, it would have been unreasonable to stop the company from continuing as a going concern while a sale was anticipated.

The Treasury's comments on the complaint

102. The then (December 2001 - see paragraph 2) Permanent Secretary to the Treasury said that in his view the actions of FSA as described in the Baird Report (see paragraph 40 and Appendix B) did not constitute maladministration. He said that he had no reason to disagree with the accuracy of the factual sections of the Baird Report and he had nothing new to add to them. However, it had to be remembered that the Report had been prepared with the full benefit of hindsight and dealt with only two years out of a story that covered more than 40 years in total. The essence of Mr P's complaint was that because FSA had failed to take regulatory action, Equitable had been able to continue to encourage investors to take out policies, without the investors being fully aware of the risks involved in investing in Equitable. Mr P had contended that, had he been aware of the true position, he would not have purchased a with-profits annuity. However, the Treasury said, providing an explanation of the risks involved in investing was first and foremost a matter for Equitable; it was for the conduct of business regulators to identify whether or not Equitable had complied with the specific risk disclosure rules and other conduct of business obligations to which it was

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subject. Although both prudential and conduct of business regulation were carried out by FSA during the period under review, they did so under entirely separate arrangements. FSA staff had carried out conduct of business regulation on behalf of PIA under contract.

103. The Permanent Secretary went on to say that FSA had accepted, with hindsight, that things could have been better handled. However, regulatory decisions had to be taken, frequently under time pressure and on the basis of the available, often incomplete, information and balancing conflicting interests. The processes by which decisions were reached were appropriate and the judgments made by the prudential supervisors in FSA were within the bounds of reasonable discretion. While, therefore, the Treasury accepted with hindsight that things could have been done better, they did not accept that the actions of FSA constituted maladministration.

Further evidence gathered from interviews and correspondence

The interview evidence cited below includes only key commentary or additional evidence given to my officers. As the interviews covered much the same ground and events, albeit from different perspectives, a good deal of the evidence given at interview served only to repeat or emphasise the same or similar points. Those points have not therefore, in general, been repeated in each section.

The Treasury

104. My staff interviewed Treasury officers A and B who had been the Head of Department (responsible for various aspects of the Treasury's interests in the regulation of retail financial services) and Director of the Financial Sector respectively within the Treasury at the relevant time. Officer A said that while Treasury Ministers would be answerable to Parliament for any policy issues arising, lead responsibility for dealing with regulated firms rested with FSA, not the Treasury. Consideration of section 68 orders had not been purely mechanistic, but had involved intellectual input from the Treasury. She had not however been involved in Equitable's applications during that period. She had had frequent, almost daily contact with FSA, including commonly having contact with them in respect of insurance regulation several times a week. The quarterly meetings discussed matters of concern, or those issues which might pose a threat to the insurance industry. Once Equitable had begun their legal action, the Treasury had explored with FSA whether Equitable's differential terminal bonus policy was acceptable in terms of meeting policyholders' reasonable expectations. Officer A had been surprised at Equitable's and FSA's defence of the policy. The Treasury's interest was to see that FSA were taking an appropriate course of action, rather than to second guess their judgments. Having discussed it, the Treasury could appreciate that the matter was arguable. They were satisfied that FSA had considered the matter and not simply taken Equitable's view. After the Court of Appeal judgment, and again after the House of Lords' judgment, the Treasury had asked FSA how confident they were that Equitable should be allowed to continue taking new business. Both times, the Treasury were satisfied that FSA had identified, researched and considered the issues before reaching a view.

105. Following the House of Lords' judgment, officer A had been surprised to see that Equitable continued to advertise actively on television. She had asked FSA whether it was acceptable for them to continue to do so and FSA had replied that responsibility for the management of Equitable was primarily a matter for Equitable's Board. However, FSA thought it reasonable for Equitable to expect to sell their business as a going concern and to maintain its market presence in order to underpin its prospects for a successful trade sale.

106. Officer A said that the outcome of the appeal had not been the one that FSA had expected. They had identified it in their scenario planning as a possibility, but had considered it unlikely. As for the "*deep-seated oversight*" comment in the briefing submitted to the Economic Secretary on 6 December 2000 (see paragraph 100), officer A (who had not been present at the 6 December meeting) said that in making that comment the officer providing the briefing had probably surmised that historically the prudential regulators had not been requiring insurance companies to balance their liabilities against their ability to meet them at current market conditions in the same way as was normal practice in other areas of the financial market. It was important to view this difference in the context that problems with insurance companies tended to develop slowly. The sudden collapse [i.e. closure to new business] of a major life company was unprecedented and they had been in uncharted territory.

107. Officer A added that the minutes of the quarterly meeting on 13 December 2000 (see paragraph 101) were accurate in terms of the subjects raised, but did not capture the full flavour of the exchange. The discussion had looked at what would happen to Equitable; what would happen to the insurance sector as a whole; what action, if any would be required of Ministers; and prepared for any questions that might need to be addressed. FSA had been asked whether they planned an inquiry, since had supervision still been with a government department, that department would have been asked to account for its actions, and FSA might be expected to account in a similar way. The meeting had also discussed the events leading to closure. Officer A said that she knew two of the three main bidders fairly well and had had every reason to believe that they were serious.

108. Officer A said that FSA had satisfied themselves as to Equitable's solvency, although with the benefit of hindsight Equitable's assessment of their position had been superficial and it would have been desirable to go deeper; FSA had not appreciated the extent of Equitable's problems until it had become apparent during the bidding process. Officer A said that this assessment was not a criticism of FSA; it was a simple statement of fact.

109. As to the question of whether or not the judgment had come as a surprise, Officer A said that the Treasury view was that the judgment had been given and

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that to labour its unexpected nature might imply criticism of the judiciary. The judgment had not been what FSA had expected, but there had been nothing to gain in focusing on that. Officer A said that the message from FSA throughout 2000 had been that Equitable had not been easy to deal with. It had been because of Equitable's intransigence that they had been selected as an early candidate for the technique of risk-based supervision (see paragraph 36). FSA had faced significant problems in supervising Equitable, and in hindsight it was apparent that they were not getting the honest and full answers that they should have been given. She concluded that the Treasury had however been satisfied that FSA had been taking appropriate steps to explore the issues.

110. Officer B said that he was drawing entirely on his memory and recollection of the Baird Report except in relation to the discussion of the Tripartite Standing Committee meeting. Passing the supervisory function to FSA had been intended to achieve the benefits of a single regulator as far as possible within the then current legislation. All supervisory expertise had passed to FSA with none retained in the Treasury, whose minimum aim had been to see that supervision was carried out as it always had been. It had also been hoped that links would develop within FSA moving towards becoming a fully integrated regulator so far as was then possible. There had been no expectation of major change in the prudential supervision of the industry, however, as the old legislation was still in place.

111. Officer B said that FSA reported to the Treasury annually; quarterly meetings had been established to ensure that FSA kept the Treasury aware of any significant issues, and dialogue had continued with FSA on an almost daily basis, although there had been no records kept of such contacts; the Treasury kept e-mails for only a limited period of time and did not record telephone calls. Through all these means and from close daily contact at all levels the Treasury had been satisfied that prudential supervision continued to be carried out as envisaged under the Contracting Out Order (paragraph 11).

112. Officer B said that, so far as the Equitable situation was concerned, FSA had kept the Treasury aware of each of the court hearings. The Treasury had not seen Equitable's position after the House of Lords' judgment as something on which they would act; the relevant expertise was in FSA and it was not for the Treasury to substitute their judgment for FSA's in supervisory matters or to query FSA's supervisory judgment, although it might be appropriate if there were concerns about implications for economic policy. The Treasury simply needed to be aware and needed in practice to be sure that the task of supervision was being carried out as it had been before; they knew that FSA were aware of the importance of the Equitable case and were giving it their attention.

113. The decision to seek a buyer after the House of Lords' judgment had been Equitable's, and FSA had considered that it was the right course to follow. It was not for the Treasury to take a different view, and officer B did not believe, even with hindsight, that the decision had been wrong. FSA had seen no reason why Equitable should not achieve a sale, and there had been the "*plan B*" option of closing them to new business if they did not.

114. As far as section 68 orders were concerned, officer B said the procedure was that FSA, having considered an application, would ask the Treasury to make an order. The Treasury would look at FSA's recommendation but relied on FSA's judgments as to what was or was not appropriate. The applications were being considered within FSA by the very same individuals who had been considering them for years previously in DTI and the Treasury. It would not be practical or appropriate for the Treasury to make a major scrutiny of such applications - there were up to 200 a year - and their scrutiny was therefore primarily limited to checks on process, which was a fairly routine task. The Treasury had sometimes asked for more information in connection with an application which they did check. It was not simply a matter of rubber-stamping. The applications from Equitable had been looked at carefully but nothing untoward had come to light. Officer B did not recall anything in particular about the application submitted after the House of Lords' judgment.

115. Turning to the 6 December 2000 briefing for the then Economic Secretary (see paragraph 100), officer B said that that had drawn largely on what FSA had said at the meeting earlier that day. The comment suggesting "*a deep-seated oversight*", however, had not been discussed at the meeting and was therefore "*somewhat hasty*".

Conduct of business regulators

116. To understand better the relationship between the two main regulatory bodies within FSA concerned with these events, my staff interviewed three officers who had been members of the conduct of business division in the relevant period. These were two former heads of the section responsible for supervising PIA Member firms (officers C and D) and the FSA conduct of business director to whom they reported (officer E).

117. Officer C had been in post up to March 1999. He said that prior to the prudential and conduct of business regulators being brought together, contact between them had been limited. If the conduct of business regulator had become aware of an issue relevant to prudential regulation they would draw it to the prudential regulator's attention, but such instances had been few and far between and there had therefore been very little contact between them. The two heads of the regulatory divisions had previously agreed that they needed to put more systematic liaison arrangements in place and from January 1999 onwards efforts had been made to do that. Asked if he perceived any conflict between their roles, officer C said that both the prudential and the conduct of business regulators were concerned with the protection of consumers: conduct of business regulation had focused on the individual investors, whereas the prudential regulators were concerned with the financial robustness of companies in being able to meet their liabilities to

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policyholders, which attached to individual consumers. It was a confluence rather than a conflict of interests. The prudential regulator was customarily seen as the lead regulator in respect of insurance companies, but in practice the concept had rarely been tested as there had rarely been any crossover between the two regulators: Equitable had been one of the first such cases.

118. Officer D had been in his conduct of business post from July 1999 onwards. He said that 'policyholders' reasonable expectations' was definitely a prudential concept, although there was a degree of overlap between the two regulators in that regard, of which Equitable was a good example. The conduct of business interest was whether Equitable were promising anything that they knew at the time of sale would not be delivered, whereas the prudential regulator would view this from a different angle, considering whether Equitable were able to meet reasonable expectations of policyholders during the lifetime of the policies.

119. Officer D said that the purpose of the lead supervision pilot (see paragraph 36) was to find out what useful and relevant information might be exchanged between regulators in order to help them make their risk assessments. Asked what level of information he would have expected from the prudential regulator with regard to a firm's financial strength, officer D said that in the first instance that was a matter for the prudential regulator; while his division had an interest, they did not need detailed information. Financial assessment was the prudential regulator's concern; a conduct of business interest would arise only if such an assessment concluded that a firm was not meeting its statutory solvency requirements. The question for the conduct of business regulators would then be how to handle that situation in accordance with the applicable PIA rules. The situation with Equitable had never reached that stage, however, as he understood that they had remained solvent and authorised to conduct insurance business; that was as much as the conduct of business division needed to know. He said that he knew that the solvency requirements were inherently conservative and that there were a number of "*cushions*" above "*straight*" solvency, that were required to satisfy the statutory solvency requirements. Asked whether the conduct of business regulator would have wanted to know of any trend that might suggest that a firm was heading for trouble, or whether they would not expect to be told until the statutory solvency margin had been breached, officer D said that it was generally speaking the latter.

120. With regard to Equitable's legal action, officer D said that the conduct of business division had been kept informed throughout the process; they had been told that Equitable remained statutorily solvent following the Court of Appeal judgment and that there was no cause for alarm and, following the House of Lords' judgment, that Equitable had decided to withhold seven months' bonus. They had not queried the prudential division's statement that there was "*no cause for alarm*" as to Equitable's financial position. They did not need to know the detailed position, although they had subsequently been sent an e-mail giving more detail. Officer D said that his understanding of the problem had been quite clear: Equitable had to cash in the reserves and had done so by suspending the reversionary bonus for the first seven months of the year. The major problem had been in respect of the reinsurance arrangements, and Equitable had solved that problem by renegotiating the terms of the reinsurance agreement. Asked whether there had been any requirement on Equitable to make any special disclosure to new policyholders after the House of Lords' ruling, officer D said that a judgment had to be made as to what was useful information; Equitable had been "*several cushions*" away from real problems. It was in the nature of insurance that there were cross-subsidies - those who claim are paid by those who do not. Equitable had made provision to meet their GAR liabilities. New policyholders were joining a pool over which others would have a claim, but that was true of all insurance funds. Officer D said that the conduct of business side would have wished to have been aware if the prudential regulator had been unhappy about Equitable's financial position, although the assumption was that they were content with a firm's solvency unless they said otherwise. He noted that Equitable's purpose in selling was not because they were insolvent, but rather to obtain a capital injection to replenish the seven months' bonus foregone and to attempt to repair their brand image. Officer D was asked whether the conduct of business regulator could require a firm that was still open to business to make specific disclosures to new customers relating to problems that it faced. Officer D said that his understanding was that where a firm had not breached the statutory solvency margin, there would be no grounds on which a special disclosure as to its overall financial position could be required to be made on top of the disclosures a company were required to make under PIA rules. Such a requirement might be seen as unreasonable and invite judicial review.

121. Officer E confirmed that he was satisfied that the prudential division had kept conduct of business colleagues informed. He had not felt any lack of knowledge about what was happening with regard to Equitable, nor had he been aware of any such feeling among his staff. They had actively engaged with the prudential regulator regarding the implications of the House of Lords' judgment, but as the matter had by then passed to FSA's relevant managing director, he personally had not been directly involved in the steps taken and had therefore had no real knowledge of what was happening at the time. He concluded that, where a company was solvent and meeting regulatory requirements, then there was a very steep barrier to a regulator taking special action, such as requiring risk warnings to be given.

Government Actuary's Department (GAD)

122. My staff also interviewed the officer (officer F) who had been head of GAD's insurance directorate at the relevant time. He said that a key factor in deciding on a company's priority rating was its solvency margin, and that consideration was given to any trends in changes as well as to the position in absolute terms. Priority two would indicate that a company was particularly weak and in need

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of early attention; perhaps 20 or 30 companies a year would be put in that category. On the basis of their 1996 returns, Equitable had been rated priority three, which indicated that GAD had identified no immediate cause for concern, although the company was marginally weaker than they would have liked. Equitable had been particularly sensitive to changes in market conditions, due to their lack of substantial free estate, and their rating would vary from year to year, normally between three and four.

123. Officer F said that the GAD survey had been commissioned following work carried out by the actuarial profession in connection with GARs; that work had highlighted areas of concern but, because companies taking part had been promised anonymity, GAD had been unable to identify the companies in question. They had therefore conducted their own survey to establish the extent of the problem and how companies were addressing it. The results showed that there was some improvement in the situation generally, in that almost all companies were making some provision for those liabilities; Equitable were a notable exception in making no provision whatsoever. It was also apparent that Equitable were more flexible than most in the terms on which guarantees were offered.

124. Asked about the progressively increasing level of Equitable's future profits implicit items, officer F said that that had simply reflected, and was, he believed, proportionate to, the increasing size of the fund and correspondingly increasing profits; it did not indicate any underlying weakness in Equitable's balance sheet. Having begun to use such items in their balance sheet in 1993 or 1994, it made sense for them to continue to do so. He explained that such concessions were particularly attractive for a mutual company in view of the limited options open to them in raising capital. Equitable's use of future profits items was in line with their culture of distributing profits fully among current policyholders when their policies became claims.

125. On the question of the section 68 application made in June 2000, officer F said that Equitable's entitlement was dependent upon the level of future profits that they could be expected to generate at a modest rate of return (in this case 5% a year), and that that would not be affected either by the House of Lords' judgment or by the level of explicit reserves on the balance sheet. Even a change in their investment portfolio (toward a higher proportion of fixed interest investments) was not considered likely to reduce future profits below the level required to support the size of the item applied for. Following the House of Lords' judgment, the reinsurance agreement had been renegotiated so that the threshold for when the agreement was triggered was reset at 60% take-up of GARs; while that meant that the benefit to Equitable was reduced, it did not affect likely future profits. Officer F was content that GAD's advice to the prudential regulator that the section 68 application met the relevant criteria remained valid after the House of Lords' judgment, and he believed that GAD had confirmed accordingly. Asked about the appointed actuary's continued use of the original resilience test (see paragraph 24) in relation to the regulatory returns, officer F said that the resilience test did not feature in the guidance on future profit implicit items. GAD could not require the appointed actuary to move to the amended test and an appropriate technical argument had been put forward as to why the old test was the appropriate one to use in the circumstances. GAD had considered what the position would be were the new test to be applied and had concluded that the difference was not significant.

126. Officer F said that the concept of policyholders' reasonable expectations was a nebulous one. However, the greatest conundrum in relation to Equitable was how to balance the expectations of policyholders as a whole against those of the GAR policyholders. His own view was that it was right to reflect the interests of all policyholders.

127. Asked about the then Treasury Insurance Division's document to FSA dated 5 November 1998, in which sudden concern had been expressed about Equitable's solvency, officer F explained that a significant change had occurred in 1998, in that interest rates had fallen from around 7% in 1997 to $4^{1}/_{2}$-5%, increasing Equitable's GAR exposure and, consequently, the level of reserving required. He said that Equitable's previous years' returns had not revealed the extent of the company's GAR exposure or their reasons for believing that no specific provision was required; that had come to light only as a result of the survey and had been highlighted by the drop in interest rates.

128. In November 2000 Equitable had been close to not meeting their solvency margin, partly due to a drop in equity values. Officer F said that his understanding was that formal regulatory action (by way of closure to new business) was possible only if a company ceased to cover the margin. The regulator could have asked Equitable to produce a recovery plan if the margin of solvency had become uncovered but Equitable would then have been able simply to cite their proposed sale as such a plan. Asked what had changed GAD's view as to the wisdom of declaring a bonus for 1999, officer F said that in January 1999 Equitable had produced further figures from which GAD had been satisfied that they could pay the bonus and continue to cover the solvency margin - even without the reinsurance agreement - although the position would be thin. It was not, therefore, the reinsurance agreement alone that had enabled Equitable to declare a bonus, though it had been a contributory factor. On the question of reinsurance, he said that it was fairly common for such an agreement to remain unsigned for some time after coming into effect, and he did not believe that the reinsurer could have refused to honour the agreement prior to it being signed. He did not believe that earlier detailed scrutiny of the 1997 returns would have led to a different outcome.

129. With regard to Equitable's view, expressed at a meeting on 29 June 1999, that it was "*inconceivable*" that the case would go against them to the extent that it eventually did, officer F said that GAD had seen no reason

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to doubt the view that, while such an outcome was possible, it was indeed unlikely for a number of significant reasons. As for contingency planning, that was a matter for Equitable rather than the regulator; GAD knew that Equitable had identified the eventual outcome as a possibility and they had been asked to have a contingency plan in place. Had GAD been of the view that the House of Lords' judgment was a probability they would not have acted differently, except perhaps to advise the regulator to persuade Equitable more strongly of the wisdom of reducing the reversionary and terminal bonuses awarded in order to build up a reserve, and even then it would have been rather late for such advice to be of significant benefit. After the judgment, there had been no reason to assume higher than normal levels of withdrawals from Equitable as even in mid-2000 there had been no real uncertainty about the likelihood that a buyer would be found, and it had been widely believed that their business would then improve.

130. Officer F said that it was not correct to say that Equitable had been unable to meet the amended resilience test 2 (see paragraph 24) in late 2000, although in any event, Equitable could fail the amended test and still be solvent, as the new test was not required by regulation to be applied during the period under consideration. Referring to his e-mail to FSA's prudential division of 16 November 2000, in which he had said that Equitable were "*unable*" to meet one of the resilience tests, officer F confirmed that this was a reference to something that was broadly the revised test. He said that his use of the word "*unable*" was meant in the sense that, Equitable's appointed actuary was in fact "*unwilling*" to apply the test and was continuing to argue against it. It was apparent from information provided by Equitable that they could meet the requirements of the new test and he believed that the appointed actuary was arguing simply on a point of principle. Officer F said, that so far as he was aware, Equitable were able to meet the revised test 2 at all times from May 2000 until their closure to new business. Officer F concluded that the relationship with Equitable had been unusual. Even given the priority rating, the regulator would not normally have engaged in the level of dialogue with a company that it had engaged in in Equitable's case.

Prudential regulator

131. The officer who had supervision of Equitable within the prudential supervision team (officer G) said that Equitable's decision to go to court had been seen as a matter for Equitable and not something in which the regulator should interfere. It was, however, important for the regulator to know that Equitable were scenario planning; they had accordingly asked Equitable what planning they had done. The prudential regulator had also considered scenarios following possible outcomes.

132. Concerning Equitable's application in 2000 for a future profits implicit item for £1.1bn, officer G said that the application had first been passed to GAD to check the calculations and, after some discussion with the prudential regulator and Equitable, GAD had been satisfied that the reinsurance agreement did not compromise the level of the future profits implicit item for which Equitable was claiming. As GAD's approval of the application had pre-dated the House of Lords' judgment, he had asked them whether that judgment would have affected their view of the application; they had said that it would not. That conversation had not been documented, but the issue had not been thought to be relevant as the judgment would not have affected the calculation in any event. He explained that while the calculation would include an element of prospective income, that was based on business already in place, and assumed that the premiums due from that business would continue to be received.

133. Officer G said that it had been apparent to them that Equitable had been under strain. While the regulator would prefer to see all companies sufficiently strong as to have no need of concessions such as future profits implicit items, they had to recognise commercial pressures. There had been a general move across the industry toward larger future profits implicit items and Equitable's applications had been well within their entitlement. The trend did not trigger any power of intervention; to dictate further to the company would not have been reasonable and could have been regarded as putting the regulator in the position of shadow director. He concluded that no regulations had been breached.

134. Officer H had been the supervision manager from July/August 1998 until September 2000. On the subject of policyholders' reasonable expectations, she said that the prudential regulator had power to intervene where those expectations were not met. This was different to statutory solvency, in that there was a statutory requirement for a company to meet the detailed regulatory solvency requirements. It was very difficult to define policyholders' reasonable expectations and there was an element of "*recognising it when you saw it*". The regulator's approach had not been proactively to review policyholders' reasonable expectations, but to note if there was some indication that these might not be being met and then to challenge companies on whether they were meeting the expectations. The company would then have to justify their position or accept that they were not meeting those expectations. The Treasury had had no evidence of any large problems, other than in relation to two or three companies, so it was not proportionate to carry out a wide-scale review of the issue in those circumstances.

135. There had been no major issues in respect of Equitable reported to her until the early autumn of 1998, once the outcome of the GAD survey of the approach that companies were taking to GARs became known. A failure to reserve at a level the regulator considered appropriate would result in intervention, but it was unlikely to be proportionate to intervene and close a company to new business just because it had under-reserved for some particular liability where it otherwise remained solvent. It would be a matter that could be considered by the regulator, but closure would not necessarily follow. There would be a likelihood of legal challenge to such a move, and the regulator would need to be very sure of their ground.

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136. As to whether the regulator might have provided guidance to the industry on the concept of policyholders' reasonable expectations, officer H said the prudential regulator had obtained copies of Equitable's case papers before the matter went to the High Court. Those had shown that the issue was being put before the court. Any definition that the regulator might have provided might therefore have been disagreed with by the courts, and so could have provided companies with a false sense of security. However, their review of Equitable's papers as part of the factual investigation had continued even so, because they wanted to be prepared to react swiftly, should the court direct the question of policyholders' reasonable expectations toward them. In their view the December 1998 guidance to all firms (see paragraph 52) and the Ministerial Statement in 1995 (see paragraph 33) went as far as the regulator could go in interpreting the law in this respect.

137. Asked whether closing Equitable to new business might have been in the interests of those who took out policies after the judgment, officer H said that the prudential regulator did have an interest in the risks to new policyholders and would stop consumers from joining a company that was not, and had no immediate prospect of becoming, financially sound. However, the main concern for new policyholders would be if they were misled as to the state of the company; that was a conduct of business matter. In the case of Equitable, the company was weak but selling the company appeared to be a reasonable plan for the restoration of Equitable to a comfortable financial position. Therefore the concerns were not sufficient to close Equitable to new business. In any event it was not clear, even after the House of Lords' ruling, that they had any grounds to do so, given that Equitable remained solvent. Any attempt would undoubtedly have met with considerable resistance and quite probably legal action.

138. Officer H said that, although FSA had undertaken detailed scenario planning before the House of Lords' hearing, their role had essentially been to prepare for the various possibilities, and not to predict which was likely to come to pass. They had concluded that, were Equitable to lose the case, the company would be left in a very tight financial position and would probably become a take-over target. The reinsurance would fall away and they would barely be able to cover their liabilities and the required minimum margin. The prudential team had followed each stage of the legal action by means of transcripts of the hearings. It was only after the House of Lords' hearing began that it became apparent that the ring-fencing option referred to by the Court of Appeal might be ruled out. There had been nothing in the court papers prior to that to suggest the weight the arguments against ring-fencing would be accorded.

139. Officer H said that, in her view, while certain things might have been done better, or more quickly, she was convinced that there was nothing that the prudential regulator could have done during the time that she was involved that would have made any difference to the eventual outcome.

140. My officers also interviewed the head of prudential supervision (officer J). Describing the prudential regulator's approach, he said that competition had been the main driving force behind the government's economic policy at the time the regulatory provisions had been set up. The aim was to allow the best possible range of financial services at the best price, and to allow the industry as much freedom as possible in terms of competition and innovation; the price of that freedom was a requirement on the industry for disclosure (that is, detailed public disclosure of financial information). Regulations were regularly reviewed to determine which were really necessary, with the aim of removing any that were not. The phrase "*light touch*" had been used to describe the approach to be taken. Against that background, it was important that the regulator should be able to demonstrate that any action taken was reasonable and proportionate.

141. As for policyholders' reasonable expectations, the concept was particularly relevant to with-profits business, where a share of profits, rather than benefits guaranteed under the contract, was often the most important benefit. The distribution of that profit was a matter for the companies' discretion, and the requirement to meet policyholders' reasonable expectations was therefore effectively a control on arbitrary decisions by the company for a policyholder who would otherwise have no redress under the contractual terms of the policy. It was for the company to decide on what it thought was reasonable, and it was then for the regulator to intervene if it considered the company was not being reasonable. That enabled the regulator to look beyond the strict terms of the contract to see that companies acted fairly in exercising that discretion. With-profits investors could reasonably expect to follow the fortunes of the company; it was for the regulator to prevent abuse.

142. Officer J said that the letter from FSA to Equitable of 1 February 1999 (see paragraph 62) was a good example of how regulation had operated in practice. The prudential division had set out their view of the facts and had expressed concerns over the reinsurance agreement, which Equitable planned to look into with the reinsurer. Their letter had expressed strong views as to the wisdom of declaring a bonus if reinsurance were not in place and had reminded Equitable that they still had to think very carefully about the possible financial implications of the court case and the risk of the reinsurance agreement being cancelled. Whether to declare a bonus, and the level of it should they do so, were matters for Equitable's commercial discretion; in exercising that discretion Equitable would also have to consider the likely adverse implications for their business were they not to declare a bonus. The role of the prudential regulator was not to determine the amount of the bonus or whether a bonus should be declared, but to consider Equitable's decision and whether or not they should object to what was proposed. The onus to comply with the regulations was firmly on Equitable, but FSA were trying to give the Society the best steer they could as to the attitude the regulator would take on the exercise of their powers to intervene. He said that the threshold for

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intervention was very high; the regulator might intervene, invoking section 45 of the 1982 Act (see paragraph 34), if it was apparent that policyholders' reasonable expectations would not be met, although they would have always to consider the possibility of legal challenge to such intervention. They had been very much in new territory in addressing this issue. Officer J said that he was not aware that the regulator had ever prevented a company from declaring a bonus, and could not recall ever before having gone so far as they had done on this occasion in seeking to influence a company's bonus decision.

143. Regarding the letter which Equitable wrote to policyholders on 1 February 2000 (paragraph 79), officer J said that the prudential division had not seen it before it had been sent. While they might have suggested changes had they seen it before issue, the letter was worded in such a way that, though it clearly set out the best possible position for Equitable, it would have been difficult to say that it was actually wrong. Action by the prudential regulator to require withdrawal or correction might have been de-stabilising for Equitable, as policyholders might have read too much into such action, and it would have been disproportionate. While it could be argued that the tone of the letter had gone too far in reassuring policyholders, the words used were not so misleading as to give the prudential regulator grounds to intervene. The conduct of business regulator had also received a copy after issue. It had not been clear that it was a PIA issue, since it was not part of the sales process, although it was intended to inform policyholders.

144. Asked why Equitable had not featured on the agenda for the quarterly meetings between FSA and the Treasury in March and June 2000, officer J said that the meetings were to allow the prudential regulator to maintain contact with, and report back to, the Treasury in general terms; they were not decision-taking meetings. The agenda was proposed by the Treasury, although it was open to FSA to offer suggestions. He suspected that the reason Equitable did not warrant inclusion was that there had already been regular contact between them on the matter and so it was not seen as a helpful use of the meeting, the purpose of which was to raise matters that would otherwise have gone unreported. He said that communications with the Treasury were often by telephone and not necessarily recorded. Asked about the prudential division's reaction to the House of Lords' judgment, officer J said they had not seen it as the most likely outcome. The judgment had been disappointing. Although Equitable had maintained the view throughout that it was unlikely that the House of Lords would decide as they did, they had grown less confident as the hearing progressed.

145. As to the increasing use of the future profits implicit items in Equitable's returns, officer J said that most firms tried not to use them for fear that that might be regarded by the financial services rating agencies as a sign of financial weakness. Many firms applied for the concession but then held it in reserve, rather than use it in the regulatory return. Equitable's applications, and the sums sought, suggested that they were finding things increasingly tough, but they were entitled to the concessions under the existing regulations; officer J pointed out that the largest amount of future profits sought was much lower than that for which Equitable had been entitled to apply under the formula in the regulations.

146. Turning to the sales process, it was officer J's understanding that bidder B's conversation with the FSA Chairman on 10 November 2000 had been the first sign that they might be about to pull out of the bidding process. Whilst that had not been taken entirely at face value, because there had been a possibility that it was a negotiating tactic on price, FSA had certainly taken it seriously. It had been the first indication that any of the remaining major players were thinking of withdrawing. Another potential bidder had been exploring ways of capping the GAR liabilities; while there were tricky issues involved, there had been no reason to suppose that they were insoluble, and the possibility had to be recognised that the threatened withdrawal could simply have been a negotiating tactic. Officer J said that in earlier discussion Equitable had said that the top-up rate was low and they had reserved for it; there had been no reason at the time to suppose that the rate would change. Once the bidding process got under way, however, it became apparent that the rate might increase, since a sizeable injection of capital into the fund would make top-ups more attractive to knowledgeable policyholders; it had been that knowledge that had prompted bidder A's concern.

147. Asked why the prudential regulator had decided after the House of Lords' ruling not to require Equitable to close to new business, officer J said that this was because to do so would be very damaging to the value of the company, and possibly fatal to the prospects of a sale. A balance had to be struck between the interests of new and existing policyholders, and the prudential regulator had taken the view that the balance was overwhelmingly in favour of allowing Equitable to continue writing new business. If a sale had taken place as expected all policyholders - new and old - would have benefited from it. Furthermore, new policyholders could be compensated if they sustained loss as a result of joining on the basis of misleading information (under the conduct of business rules). If new policyholders had been aware of the risks, then that was a matter for them. Officer J said that it was fair to say that the collapse of the bidding process had occurred quite suddenly and until very shortly beforehand there had remained a realistic hope that a sale would go ahead.

148. As to the comment in the Treasury briefing of 6 December 2000 (see paragraph 100) to the Economic Secretary, which suggested "*a deep-seated oversight*" on the part of the regulator, officer J said that he did not accept that and in any case did not know what was meant by it. The prize of achieving a sale was of sufficient value to make it worth pursuing to the end. Asked about the contention in the Treasury note of the quarterly meeting on 13 December 2000 that neither Equitable nor FSA had recognised the extent of the GAR liability (see paragraph

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101), officer J pointed out that the note was dated 9 January, some weeks after the meeting. He said that he had not seen the note previously, and that had he done so, he would have asked for it to be amended as he did not recognise or accept the substance of it in a number of respects. He did not, for example, accept the comment attributed to him in the note of the meeting in respect of the House of Lords' judgment being completely unexpected.

149. Officer J said that he did not believe that there was anything that FSA could have done differently that would have significantly altered the outcome of these events. The only other option would have been to close Equitable to new business after the House of Lords' ruling, which would simply have precipitated the situation that eventually transpired but which would have given Equitable no chance to try to save itself.

150. The Director with responsibility for prudential regulation told my staff that, in terms of the court action, FSA had identified a number of possible outcomes (including the eventual outcome); they had then done an initial analysis and had not thought that the eventual outcome was sufficiently likely that the regulator had to act as if it was the likely outcome. The outcome was in that sense unexpected - but not unanticipated. Equitable had taken advice and that advice had made them believe that the case was worth running, although they and FSA had recognised that all litigation was uncertain. The internal legal advice given to the regulator did not differ from that view.

151. The Director said that, when the unlikely outcome began to look likely, a colleague had met with Equitable who had said that they would seek a buyer. As long as a sale was a realistic option, FSA would not have wanted to frustrate it. There were other options open to the management of Equitable, including a moratorium on new business; Equitable could have restricted new business and re-balanced their portfolio. However, they had wanted to restore the bonus, which the other options would not have allowed them to do. If Equitable had been "*a dog*" FSA would not have let them proceed to a sale but, as matters stood, they would have struggled for grounds on which to close them. While it was true that Equitable had suffered something of a reversal in the courts and were paying more to some policyholders than to others, they had remained solvent and there had been many companies that had been interested in them. If then the business could not be sold, they would have been weakened, because they would have declared their hand, but would not necessarily have had to close to new business. It was not obvious, even at a later date, that closure was the right option. It was a balance between allowing policyholders to realise economic value in a sale with the relatively remote danger of the company becoming "*a dead duck*". He remained convinced that sale had been an appropriate strategy for Equitable to pursue. It had seemed a reasonably robust and sensible approach in principle. The primary obligation was on the company to decide their strategy, not for FSA to dictate to them. Their actions had been within the reasonable range of possible actions.

152. The Director went on to say that the prudential division had put effort into informing conduct of business colleagues about what was happening - communications between them had worked pretty well, especially in the case of Equitable. The prudential division's impression was that their conduct of business colleagues had looked at the situation and felt that Equitable appeared to be acting within PIA rules. Again, the conduct of business division had been left in no doubt as to what had happened in respect of the House of Lords' judgment, but there had been doubts about what that had meant for the future. Conduct of business colleagues had recognised that Equitable had been weakened, but took the view that, as Equitable were meeting the required minimum margin, then they would police Equitable's compliance with PIA rules in the ordinary way.

153. The Director was asked about the relevance to the failure of the sale of the company of the liabilities arising from GAR policyholders having the right to make additional payments to top-up their funds. The Director said that the two final bidders had both identified that they needed to do something about the top-up liabilities, and indeed they had devised means to avoid or limit those liabilities (including the method ultimately employed by the eventual purchaser of the operating business) and had continued to engage in serious and protracted negotiations after learning of the issue. It was important to note that this liability was not in practice unlimited. The liability was self-limiting for a number of reasons, not least because there was a limit contained in the tax regime, but there was also the fact that policies could be taken on a single life only. The top-up liability had therefore been an issue, because there was a cost to capping the top-ups which meant that the price a potential purchaser would be willing to pay would be necessarily lower. A lower purchase price in turn affected goodwill because it reduced the sums available to be distributed to the policyholders; goodwill was one of Equitable's main assets given their client base. Thus, whilst the top-ups issue was a factor in the bidders' consideration of Equitable, it was a factor that affected the purchase price, rather than a factor which left an unquantified liability to be met by a prospective purchaser. It was therefore significant, but it had not been determinative. The bidders had withdrawn due to a combination of reasons, of which this had been just one factor amongst several.

154. The Director said that there was nothing that he would have done differently in relation to the sale process. He believed that none of the decisions the prudential regulator had taken had been significantly flawed.

155. FSA's relevant managing director said that it was not the regulator's role to tell a company what action they should take. In the case of Equitable's legal action therefore, the regulator's role was to see that the company had assessed the possible outcomes and the urgency with which they would need to act in response to each. Intervention by the regulator would be appropriate only if a particular proposed course of action would pose a serious risk to policyholders, and such intervention would be of benefit. They would also need to tell the company if

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any action proposed under the scenario planning would contravene statutory requirements, and to consider the suitability of any company proposing a takeover. It was his view that there was nothing that had not been done, either by Equitable or the regulator, that would have made any difference to the eventual outcome. Equitable's decision to sell following the House of Lords' decision had not come as a surprise to FSA and the prospects of a sale were seen as good. All professional opinion at the time was that a sale would generate a sizeable premium; Equitable had appointed a well regarded firm to advise on the sale; and it was known that a number of companies had expressed interest in buying Equitable in recent years.

156. The progress of negotiations was, from FSA's viewpoint, entirely what they would have expected. Although most of the 15 companies expressing an initial interest had dropped out, that was usual, and no more than two or three would be expected to reach the final stages. The managing director added that it was also to be expected that very difficult technical issues would arise at the later stages of negotiation, partly due to the progressively narrowing focus on increasingly specific aspects of transferring the business, and perhaps to apply leverage over the price or to obtain some form of regulatory concession. None of the potential bidders had been regarded by FSA as undesirable, although there were certain regulatory issues that would have had to be addressed had a sale gone ahead.

157. Asked whether Equitable's subordinated loan, reinsurance agreement, and future profits implicit items should have been seen as a sign of financial weakness, the managing director replied that that was certainly not so of the subordinated loan, as the ability to obtain such a loan could even be seen as a sign of strength. The reinsurance had resulted from pressure applied by the regulator and GAD to reserve more fully. He said that the future profits implicit items were slightly different, although he understood that no such application had ever been refused where the statutory criteria were satisfied. The concept had no parallel in any other area, but provision was made for it in EU directives, although it was to be phased out by 2009. FSA had inherited such concessions - final responsibility for which rested with the Treasury - as part of the regulatory system, and insurers expected to be able to take advantage of them. FSA would have needed to put forward a very strong argument if they had wished to refuse Equitable's applications when the concession had been granted so widely to others. The managing director concluded that there had been no real prospect of regulatory action against Equitable unless they had breached regulations. While he would have preferred to see them hold a substantial estate, their position had been entirely permissible within the regulations and provided no grounds for regulatory intervention.

Later developments

158. In a letter of 9 January 2003 the Director told my staff, in answer to their further queries, that in FSA's view, Equitable had to reserve on the assumption that close to 100% of [GAR] policyholders would take up their GAR option. He said that FSA accepted that reserving at a level that assumed 100% take-up could be excessive, given that take-up was very unlikely to reach this level. [According to Equitable, take-up at no time exceeded 50%.] At opposite ends of the spectrum were Equitable, who saw no need to reserve, and FSA who wanted reserving close to 100%. He said that a substantial body of opinion in the industry and the profession would have seen reserves at somewhere between 75% and 100% as appropriate. The Director concluded that it was fair to say that Equitable themselves believed that the position FSA took on reserving was wholly unreasonable. There was a body of opinion in other companies and among other actuaries that FSA's position was at the conservative end of the spectrum of views on reserving. My staff have received independent expert actuarial opinion that a prudent allowance for the GAR exercise rate would more likely have been in the region of 75%, maybe even a little lower. The limiting factors include contractual restrictions that applied within many policies when a GAR was exercised and taxation considerations. The latter would make it perverse for many policyholders to exercise the GAR in full even where the guaranteed rate was well in excess of current rates. Only when the GAR excess became very large would a higher range apply, reaching at its upper level to 90% - 95%.

159. In a further letter also of 9 January 2003, at the request of my staff, the Director followed up the point he had made at interview about the importance to the potential bidders of top-ups (see paragraph 153). He said that top-ups were a highly significant factor to potential purchasers. However they were not a "*deal-killer*". He said that the issue had been identified by potential bidders and advice had been obtained by the bidders as to whether the problem could be dealt with effectively. Some bidders had believed that they had devised workable ways of capping the top-up liability. This added to information in an earlier letter of 5 November 2002 in which the Director had said that, in November 2000, the potential bidders had devised workable plans to overcome the top-up issue as an obstacle to the sale, including the method ultimately employed by Equitable. He acknowledged that the relevant managing director's Board report of 15 December 2000 had put a greater emphasis on the ability of policyholders to top-up their polices as a reason for the potential bidders' withdrawal than had his own oral evidence. However, he still did not believe his account to be inconsistent with the contemporary documents. The additional cost to a bidder of capping the top-ups meant that they would offer a lower purchase price. This in turn would affect the goodwill that was one of Equitable's main assets. It was the effect of top-ups causing a lower purchase price rather than there being an unquantified liability to be met by a prospective purchaser that was significant.

160. The Director said that the key point in his view was that the final outcome of the combinations of factors leading bidders to withdraw could not have been, and was not, known to FSA any earlier than when the last remaining potential bidder [A] withdrew. On 6 November 2002 the managing director also wrote explaining that his Board paper of 15 December 2000 was not intended to

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brief the Board on the reasons for the failure of the sale process. He said that, had it been, he would have explicitly linked the top-up issue with goodwill and would have explained that other changes in the market place were also significant factors for bidders and part of the combination of factors causing them to withdraw.

Findings

161. My investigation has shown that when FSA began to operate as the prudential regulator on 1 January 1999 there were two key issues that they had to address in relation to Equitable. The first was the basis upon which Equitable were reserving for their significant potential liabilities arising from the GAR options contained within their individual and group personal pension plans. The second was the question of the legitimacy of the differential terminal bonus policy they had adopted to manage the actual GAR liabilities arising, and whether that could be said to meet policyholders' reasonable expectations.

162. The second issue had been taken out of FSA's hands to some extent by the time the Treasury handed over to them responsibility for prudential regulation, in that two significant events had taken place. First, on 18 December 1998 the Treasury had issued guidance to life companies (DD1998/5), which effectively said that operating a differential terminal bonus policy was not necessarily contrary to policyholders' reasonable expectations and could therefore be a legitimate practice. The factors which determined legitimacy in each case would be the wording of the contract involved and how that had been presented to the policyholders. That guidance was supported by GAD and the wider actuarial profession (the Faculty and Institute of Actuaries). Secondly, Equitable had already signalled their intention to test the legitimacy of their differential terminal bonus policy in court.

163. As for the reserving issue, the actuarial profession had become alert to the need to explore the nature of GAR liabilities and the approaches adopted by companies to reserving for them as an industry-wide issue only from late 1996/early 1997 onwards. That, at least in part, appears to have been due to the fact that the statutory regulatory system did not require GARs to be shown in the regulatory returns as an explicit liability until they obtained a clear value.

164. It was only therefore once interest rates had fallen significantly from those prevailing in the period when the Equitable GAR policies had been written (that is, up to June 1988), together with the fact that improving mortality required the revision of commonly applied actuarial assumptions, that the issue had become highly significant. (Appendix D demonstrates how rapidly the relative value of GAR policies was changing.)

165. The question of whether the failure to recognise earlier the particular relevance of the GAR issue in relation to Equitable could be described to any extent as resulting from a shortcoming of the regulatory framework in general, of that part of the legislation governing the regulatory returns, or on the part of one or more of any of the key players in these events - namely, Equitable themselves or their auditors, the actuarial profession or the relevant regulators and their advisers - is not a matter on which I can comment. The question relates to a period outside the timeframe of this investigation, but in any event all of those bodies, other than the Treasury and FSA as prudential regulators, and most of those matters (such as the relevant legislation) are outside my jurisdiction.

166. My investigation is concerned solely with the question of how FSA, acting as prudential regulator on the Treasury's behalf from 1 January 1999 onwards, responded to Equitable's position and the possible wider consequences for Equitable policyholders, and whether that response could properly be described as maladministrative and leading to injustice. All of that, however, has to be set against the backdrop of Equitable's then reputation and published practices. Equitable were a long-standing, successful and still growing company, which had a high public profile, were generally highly regarded and were seen as a market leader in the life insurance business. However, they were also unusual in terms of having no substantial free estate, together with a well-publicised policy of disbursing surpluses each year through annual bonuses, and had for many years in the past offered very generous and flexible GARs, which consequently represented a significant proportion of their business.

167. I have decided that the best way to present my consideration of these events and the conclusions I have reached is to look at how the situation in respect of Equitable developed, and how the prudential regulator responded, in relation to the different stages of the court action relating to Equitable's differential terminal bonus policy, which was the key issue driving these events.

Period from 1 January 1999 to the Court of Appeal judgment (January 2000)

Regulatory solvency

168. There is no doubt that in late 1998 the Treasury had briefed FSA in considerable detail about Equitable's weak regulatory solvency position and had indicated a possible need for the regulator to intervene if Equitable either: a) continued to refuse to accept the need to reserve to the level GAD thought appropriate to cover the GAR liabilities, or b) declared a bonus without the regulator's prior agreement. However, that position stood to be resolved, at least to an extent sufficient to satisfy FSA's requirements in relation to reserving, by the reinsurance agreement Equitable were in the process of negotiating. By 1 January 1999, when the FSA took over as prudential regulator, the situation had therefore moved on sufficiently for the Treasury's earlier indications of a possible need for immediate intervention to be regarded as no longer valid.

169. Nonetheless, it was certainly not true to say that FSA knew that Equitable's position needed to be closely monitored and did nothing. On the contrary, it is very

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evident from the activities described in detail in the chronology that, whatever view one might take of the prudential regulators' stated approach to their role (as described in paragraph 35), they could not be criticised for a lack of concern about Equitable and the position of their policyholders nor could their approach in respect of Equitable be described as 'passive'.

170. It is clear that a great deal of thought and discussion went into the situation and that FSA's prudential division, with GAD's support, made continued efforts to try to ensure that Equitable took appropriate action to secure adequate reserves and that Equitable did not take steps which would have worsened their solvency position. This was demonstrated by FSA maintaining their stance on the need for Equitable to conform to the reserving requirements in the face of Equitable's strong resistance, (Equitable had submitted Counsel's opinion that the prudential regulator's approach to reserving was unreasonable; and had also threatened judicial review if FSA continued with that approach); FSA continuing to urge Equitable to be cautious about the bonuses they paid (warning them that they would use their powers to intervene if Equitable attempted to declare a bonus before FSA were satisfied that they had sufficient reserves in place); and their requiring submission, some three months ahead of schedule, of Equitable's 1998 regulatory returns, which were then subject to early detailed scrutiny. I note that the latter action was specifically required because of FSA's concern that the 1997 regulatory returns might have given policyholders and potential policyholders a misleading impression of Equitable's financial position (see paragraph 63). This was seen as the only way forward as the Treasury had previously received legal advice (see paragraph 55) suggesting that they had insufficient grounds to take action against Equitable for not previously having included the GAR liabilities in their regulatory returns, and (see Appendix C, 11 December 1998) that they had no powers to require Equitable to reissue or amend the 1997 returns.

171. FSA (with GAD) cannot therefore be said to have addressed the GAR reserving issue - and the linked possible misrepresentation of the strength of Equitable's financial position - in anything less than a resolute manner. But that still leaves the question of whether, having seen Equitable's position as so serious that regulatory intervention might be required, it was appropriate for the FSA to allow Equitable to rely to the extent that they did on reinsurance and on the future profits implicit item effectively to balance their books. Should these have been regarded largely as 'window dressing' as they did not improve Equitable's underlying financial position, but were mainly technical ways of enabling Equitable to satisfy the statutory regulatory requirements without actually increasing their reserves? Even more significantly, Equitable then used them not only to balance the books, but as grounds for their being able to declare a bonus of 5% for 1998 (when they were contractually bound to pay 3fi% only to the guaranteed interest rate policyholders - who were in the majority). I examine these two matters in turn.

Reinsurance

172. FSA (on GAD's advice) did not discourage Equitable from considering reinsurance, as it was within the rules. As I understand it, reinsurance was an accepted way of meeting the regulatory solvency requirements, and not unusual in the insurance industry. I can understand why, with the benefit of hindsight, GAD later took the view that Equitable had probably not been wise to rely on it to the extent that they did. Given that the agreement stood only for as long as the differential terminal bonus scheme remained unchanged, and would otherwise fall to be renegotiated (see paragraph 66), it meant that, if Equitable lost their court case (a factor outside Equitable's control), they would be left in a considerably weakened negotiating position. Nevertheless, as reinsurance was an accounting practice which was accepted as legitimate by the profession and the industry, and was backed by FSA's own professional advisers, I do not see how FSA could reasonably have refused to accept its use in Equitable's case.

173. I would add in this respect that I note that FSA, with GAD's guidance, did not simply accept Equitable's word that the reinsurance agreement did what it was supposed to do. They took an active interest in the terms of the agreement and suggested to Equitable a number of amendments to the terms to make the agreement as robust as possible and, most importantly, to ensure that it was subordinate to policyholders' interests. I considered whether the condition attached to the agreement (that it only stood as long as the differential terminal bonus policy remained unchanged) should have led FSA to question whether they should accept the reinsurance as valid for solvency purposes. The expert advice I received was that the condition could be seen as a general and (given the nature of the agreement) properly prudent provision, backed up by an understanding as to how certain possible outcomes of the litigation might be handled. It did not render the reinsurance agreement worthless if the policy changed, it simply meant that the agreement fell to be renegotiated. In the event, following the House of Lords' judgment, Equitable were able quickly to renegotiate a revised agreement. I am therefore satisfied that FSA's acceptance of the reinsurance agreement was not maladministrative.

174. I note that the agreement was not signed until 30 September 1999 by the reinsurer and 11 October 1999 by Equitable, some considerable time after it had first featured and been relied upon in the regulatory accounts. Although that meant that the agreement was only signed some time after it was deemed to take effect, I understand that that was of no consequence. The expert advice I have received supports the evidence given by FSA staff that a delay of this kind was not uncommon, and that the reinsurer was effectively on risk once the terms had been agreed. That meant that the reinsurer, if called upon, could not have refused to honour the agreement on the grounds that it was unsigned.

Future profits implicit item

175. I note that Equitable made applications for future profits implicit items for £500m in 1994, £850m in

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June 1998, £1.9bn in December 1998, and then £1bn in March 1999. Were FSA right to allow Equitable to rely so significantly on future profits implicit items in this way? When considering this matter, it is I think important to bear in mind that this was not simply a concession made to Equitable. It was a concession available to all [life] companies under the 1982 Act and Equitable were by no means the only company to take advantage of it (see paragraph 25). Further, the 1994 Regulations set out specifically how the item was to be calculated.

176. According to GAD (see paragraph 124) the increase in the level requested was proportionate to the increasing size of the fund and correspondingly increasing profits (that is it reflected proportionately the growth in Equitable's new business). It did not therefore necessarily indicate an underlying weakness in Equitable's balance sheet, although companies did not like to use future profits implicit items unless absolutely necessary as they thought they would be perceived as a sign of weakness by financial analysts. (This was confirmed by my own actuarial advice.) Further, the large increase from 1998 onwards was specifically to meet the additional GAR reserving requirement FSA had required Equitable to make.

177. I note also officer F's comments that Equitable had been relying on future profits implicit items since 1994, and his explanation as to why such concessions were particularly attractive to mutual companies. The applications were accordingly neither something new, nor could they be described as unexpected. I see also that the sums applied for, although large and increasing, were never fully used by Equitable in their regulatory returns (they used only £850m of the £1.9bn applied for in December 1998) and were still well within what Equitable could have legitimately applied for under the regulations. Indeed as officer J pointed out (see paragraph 145), the largest future profits implicit item sought by Equitable was much lower than the sum for which they had been entitled to apply. That being the case, it is difficult to see on what grounds FSA could reasonably have refused Equitable's applications. Indeed had they done so, it seems possible that Equitable could have had strong grounds for complaint (and possibly judicial review action) on the basis that they were being singled out unfairly for action which would almost inevitably drive them close to regulatory insolvency.

Differential terminal bonus policy and policyholders' reasonable expectations

178. It could, perhaps, be argued that the main point at issue here was the guidance issued by Treasury on 18 December 1998, which appeared to legitimise, albeit indirectly, Equitable's approach to differential terminal bonuses. Did that give false comfort, particularly to Equitable, and thereby add to the false view of the strength of Equitable's financial position?

179. I can see how on the surface - and with the benefit of hindsight - the guidance might be viewed in that way. But it also has to be remembered that the guidance was issued before Equitable started their court action, so it was clearly not the case that they simply relied on it as justification. It was also issued before FSA took on the role of prudential regulator. That said, it is clear that it reflected FSA's own view that there were legitimate arguments in support of the differential terminal bonus practice in certain circumstances. Was that so misguided a view that it might be considered to be maladministrative? Certainly the then Economic Secretary's initial personal response (19 November 1998) to the proposed guidance was that the practice Equitable were operating did not fit in with her own view of what GAR policyholders might reasonably expect.

180. Nevertheless, I believe it has to be recognised that the guidance also reflected general thinking in wider actuarial circles, and that the Faculty and Institute of Actuaries supported it (see Appendix C, March 1999). I note also that Equitable were by no means the only company adopting that practice. That said, although not unique, Equitable were extremely unusual in terms of the size of the company, the proportion of their business affected and therefore the level of their exposure if the practice was judged to be unacceptable. The key point, however, is that the guidance made absolutely clear that the legitimacy of the practice in respect of each company would depend wholly on whether the company had communicated their policy clearly to policyholders. FSA took the view that, if the company had done so, then there could be no question of policyholders' reasonable expectations not being met. That does not seem to me in itself to be an unreasonable approach to take, and certainly not maladministrative.

181. I note, however, that what that guidance did highlight was a weakness in the then current regulatory framework, in terms of the possible drawbacks arising from the lack of a co-ordinated approach by the prudential and conduct of business regulators. Some of FSA's conduct of business staff clearly felt that the guidance could be seen as unfortunate from their viewpoint (see Appendix C, 18 January 1999) and that it served to underline how the two regulators might take a different view on certain issues, in this case on policyholders' reasonable expectations. However, any potential difference in views on what might constitute policyholders' reasonable expectations in relation to Equitable's differential terminal bonus policy had been rendered largely academic once Equitable had decided to take the matter to the courts (see Appendix C, the letter of 18 December 1998 to the Treasury). FSA's prudential division consequently decided that there was little point in them putting significant further effort into trying to reach a firm view on policyholders' reasonable expectations in this regard, as the court's judgment would properly be expected to influence that view. Given the potential significance of the anticipated court ruling to the question of policyholders' reasonable expectations, the decision to await the court ruling was, in my view, reasonable.

182. That did not, however, mean that FSA's prudential regulation division did not continue to explore other issues relating to policyholders' reasonable expectations. For example, they called for Equitable's

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bonus recommendations and notices to be sent in for review, and shared those with conduct of business colleagues to get their expert view. Early submission of the 1998 regulatory returns meant that the detailed scrutiny was able to be completed well ahead (some ten months) of the normal schedule (see paragraph 19). That in turn meant that FSA's prudential division were then much better placed than they would otherwise have been to assess the strength of Equitable's stance in the various ongoing debates they were having over matters such as the reserving requirements, and would put them in a position to react quickly to reassess whether Equitable were able to meet policyholders' reasonable expectations if the courts either referred the matter back to them or gave a view on the matter.

183. The concept of policyholders' reasonable expectations was not defined in statute at the time and was not at all straightforward. I note the various descriptions of it put forward by officers (see paragraphs 118, 126, 134 and 141), including the view of officer F that it was "*nebulous*", and of officer H, that it was a matter of "*recognising it when you saw it*". It is, perhaps, unfortunate that the legislation was not clearer from the outset as to how the concept should be interpreted (in that respect, I note that the term does not reappear in the legislation relating to the current regulatory framework). The key difficulty with the concept was, as officer F indicated (see paragraph 126), that it gave no indication as to how companies were to balance the differing expectations of different groups of policyholders, for example GAR and non-GAR, existing and potential, particularly when action taken to meet one group's expectations would impact adversely on others' expectations. That judgment was rendered all the more difficult in Equitable's case because of their lack of significant free estate or shareholders. The company could not therefore use their reserves or call for an injection of cash to mitigate such adverse effects. That said, FSA's decision to await the outcome of the court case was not an entirely risk free strategy, because in the meantime, policyholders' reasonable expectations would be being further influenced by then current events and by the way that Equitable were presenting those events to existing and potential policyholders. On balance, however, in all the circumstances, and given the other even more fundamental discussions ongoing between Equitable and FSA about reserving levels for the purposes of regulatory solvency (which would also ultimately impact on whether Equitable could meet their policyholders' reasonable expectations), the decision on FSA's part not to rush to a view until they had the courts' final judgment on the matter was not in my view unreasonable.

Did FSA miss any significant factors?

184. FSA's prudential division carried out scenario planning on the possible outcomes of the court case (see Appendix C, 9 June 1999) and they also considered Equitable's own scenario planning (see Appendix C, 21 June 1999). I note the views of officer H (see paragraph 138) and the relevant managing director (see paragraph 155) that the prudential regulator's role in this respect was essentially to prepare for the various outcomes by identifying any action which might be required of Equitable and of the regulator in each scenario, and to ensure that Equitable carried out similar preparations.

185. One factor that FSA did not specifically identify in that planning was that, if Equitable lost their case, their GAR liability could increase even further - possibly significantly - because of the potential for top-up payments (that is the fact that many existing GAR policyholders were able to make additional premium payments which would also attract GARs). I note that, when asked to assess that potential liability, Equitable had previously told the Treasury (see Appendix C, 11 November 1998) that they were unable to assess the likely impact of such future premiums without scanning all of the files at the year end to determine where entitlement to pay further premiums existed. The papers do not show why FSA's prudential division did not follow up on that point with Equitable, although I note that GAD's discussion with Equitable on 29 January 1999 had revealed that Equitable had, in any event, included an allowance of £450m for future top-ups in their reserving calculation. The issue did not resurface again until Equitable raised it themselves in a paper to their Board (they sent a copy of the relevant Board paper to FSA on 20 April 1999) which discussed possible ways of limiting the growth in GAR business within the overall context of measures open to the company to protect their regulatory solvency position. FSA did not pick up on this at the time, either as a then current reserving issue or as a potential future problem, despite a clear signal in Equitable's comments that they could not see any way in which they could prevent top-up payments, nor could they assess with any degree of accuracy the potential scale of the problem. It could perhaps be argued that FSA should have pressed Equitable to do more work on this issue in this period and on possible ways of resolving it. That said, I recognise that FSA were already devoting a significant amount of time to issues relating to Equitable, and were encountering significant resistance from them to reserving in full for the liabilities which they could far more easily assess. I can therefore understand why that further issue (which, once the reinsurance was in place offsetting any increased reserving liability, would be relevant only if Equitable lost the court case and decided to seek a buyer) was not seen as a priority at that time.

186. Another issue which surfaced during this period (from 1 January 1999 to January 2000) was the role of the conduct of business regulator in relation to the continuing information provided to policyholders after the sales process had been completed. As I have already indicated, the prudential division raised the matter with their conduct of business colleagues in connection with bonus notices, which they considered might have given policyholders unrealistically high expectations of the terminal bonus pay-outs they could expect. Subsequent exchanges between the prudential and conduct of business regulators indicated that, while the prudential division clearly believed the content of post-sales information to individual policyholders to be a matter for their conduct of business colleagues (see Appendix C, 24 June 1999), the latter for their part did not consider that such matters "*fitted*

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comfortably within their remit" and said that they would therefore have to have serious concerns about a document before taking action (see Appendix C, 20 and 23 September 1999). That suggested a potential gap in the regulatory framework, and it might be argued that (given the importance of the issue in question, not least for policyholders and their reasonable expectations), both the prudential and conduct of business regulators could have done more to clarify their respective responsibilities. In the event, at this point the prudential division appear to have accepted conduct of business colleagues' view that, from a PIA perspective, the notices were not misleading, and taken that as a sign that no further action was necessary. I do not consider that that was a wholly unreasonable decision in itself for the prudential regulator to have reached, given the advice they had received. Nevertheless, as a result of the matter not being formally clarified between the regulators at that point, the issue remained somewhat unclear and was to resurface again several months later.

Overall, was there anything further that the prudential regulator should have done in this period (January 1999 to January 2000) which would have provided greater protection for Equitable's existing and potential policyholders?

187. I do not consider that there was for a number of reasons. First, although there was no doubt that Equitable were financially weak, that was not something new or surprising. It was a direct consequence of the way that they had always conducted their business, paying out as much as possible in annual bonuses to policyholders and not carrying excessive reserves. That automatically meant that they were inherently weaker than most life companies. Equitable had never made any secret of this, indeed it had been a major part of their sales strategy. An inescapable consequence of that policy, which they also publicised widely, was that Equitable's policyholders would follow the fortunes of the company.

188. It was also clear from Equitable's published material that they were particularly sensitive to changes in market conditions, again because of their lack of substantial free estate and lack of a means to raise quick cash injections (from shareholders). That vulnerability had led to the internal priority rating which GAD had given them varying from year to year (see paragraph 122). It was certainly true that the combination of lower interest rates and changed mortality assumptions had raised the stakes sharply for Equitable, leaving them more exposed than during earlier equity market falls. However, providing their differential terminal bonus policy was legitimate, and it has to be remembered that the High Court ruled during this period (on 9 September 1999) that Equitable were entitled to operate that policy, the professional advice from GAD was that it was still possible for them to manage the situation and work themselves out of their regulatory solvency margin problems. In the light of that, it is difficult to see how FSA could reasonably have argued that that continuing weak financial position, arising from the very practices which had been at the heart of the company's highly successful marketing strategy throughout their existence, had suddenly become grounds for the prudential regulator to consider closure of the company to new business.

189. Most important of all, Equitable remained technically solvent. At no time did they breach the required minimum margin, and they were able to meet the required resilience tests in their regulatory returns. It is important to remember that solvency in the regulatory sense is not at all the same as Companies Act solvency. As has been explained (see paragraph 22), regulatory solvency is set at a much higher hurdle than what is commonly understood as solvency ("*several cushions above it*", as officer D described it - see paragraph 120) and is essentially a trigger point to alert the company and regulator to the fact that the financial position is becoming critical and that an action plan is required to restore the company to a sound financial position. FSA took the view that, as Equitable had not breached the regulatory solvency requirements as set out in the statutory framework, they had no grounds for formal intervention on solvency grounds.

190. Another possible ground for intervention at that point would have been if FSA believed that Equitable were unable to meet their policyholders' reasonable expectations. Although it is clear that the prudential regulator considered that there was a question mark over whether these were in fact being met (because of the differential terminal bonus policy), they were unable to reach a conclusive view of the matter until the court had given a final ruling. It would have been premature for FSA to have intervened on those grounds at that stage. Had they done so, and had the court taken a different view, FSA would undoubtedly have been held responsible for making the position of the Society and their policyholders significantly worse.

191. FSA were nevertheless concerned to ensure that Equitable's financial position was not misrepresented to potential policyholders, which is why they pressed them so hard on the reserving issue, and why (having discovered that there was nothing they could do about the potentially misleading impression given in the 1997 returns) they called for early submission of the 1998 returns. Those gave a much more realistic view of Equitable's weakened financial position.

192. The use by a regulator of their powers of intervention is a discretionary decision. Under section 12(3) of the 1967 Act (see paragraph 5) I cannot question such a decision unless I have seen evidence that it has been reached with maladministration (either that the process by which it was reached was faulty or that the judgment reached was outside the bounds of reasonable discretion). I have seen no evidence that that was the case here. FSA were monitoring Equitable's solvency position and clearly thought through what the likely impact of any potential regulatory action would be on Equitable's policyholders. They reached the conclusion that formal intervention during this period would be disproportionate (and was likely to be challenged in the courts), and that it was in the policyholders' best interests for the FSA to work with Equitable with the aim of strengthening their

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solvency position to ensure that they could meet their policyholders' reasonable expectations, and to present their financial position as accurately as possible. I do not consider that to have been an unreasonable course of action for FSA to have chosen.

Period from the Court of Appeal judgment (21 January 2000) to the House of Lords' judgment (20 July 2000)

193. Should the fact that two of the three Court of Appeal judges ruled against Equitable have set alarm bells ringing at FSA and have prompted them into some form of intervention? I do not see that that necessarily follows. The High Court had, of course, ruled in Equitable's favour and had been supported by the prevailing view of the actuarial profession at the time that awarding differential terminal bonuses could be an acceptable practice - albeit it was not a common one. Further, as FSA's legal advisers pointed out (see Appendix C, 31 January 2000), each of the four judges who had up to then considered the case had arrived at their varied conclusions for different reasons.

194. Nevertheless the Court of Appeal ruling undoubtedly changed the landscape in that it underlined the fact that the issue was not as clear-cut as Equitable had presented it. It also brought to the fore the issue of ring-fencing, when one of the judges commented that in his view ring-fencing could be legitimate, which would significantly limit the impact of an adverse ruling on Equitable's position. However, given that it was common insurance practice to treat the various types of policyholders differently (for example, insurers generally declared bonuses by class of policy and in line with the characteristics of different policies), I can understand why FSA considered it unlikely that the courts would rule otherwise (see Appendix C, 2 March 2000).

195. That said, I note that the judgment did not prompt FSA to consider in any real depth the potential ramifications (not just for Equitable but for the life industry as a whole) if ring-fencing were not permissible, until it became clear through the House of Lords' hearing transcripts that that was a possibility. I note also that FSA did not revisit their possible outcome scenarios after their preliminary assessment on 28 January 2000 until a few days before the House of Lords' judgment was due to be announced, despite a director on the Equitable Board telling the managing director of FSA on 4 July 2000 that there were "*straws in the wind*" that Equitable might lose in the House of Lords and that they were considering the consequences of that for the Board of Equitable. Had FSA done so, they would have had more time to consider the potential consequences in greater depth; I cannot, however, see that that would have had any impact on subsequent events.

196. I note also that the prudential division did not draw to the attention of either Equitable or of their conduct of business colleagues their concerns about Equitable's letter of 1 February 2000 to policyholders. I accept that it is difficult to envisage that Equitable would have been persuaded to have done anything about it after the event. I also recognise the strength of officer J's comments (see paragraph 143) that the letter had been worded very carefully in such a way that, while it could be argued that the tone of the letter had gone too far in reassuring policyholders, the words used were not so misleading as to give the prudential regulator grounds to intervene. I note further his view that action by the prudential regulator to require withdrawal or correction might in any event have been de-stabilising for Equitable, as policyholders might have read too much into such action, and that such action would therefore have been disproportionate. It could be argued that, if FSA had taken up the matter as a policyholders' reasonable expectations issue and reminded Equitable of their responsibilities in that regard, then that might have influenced Equitable to think more carefully about what they said to policyholders in the future. However, that can only be a matter for speculation, and given Equitable's robust responses to the prudential regulator on other issues, it seems to me unlikely that such action would have altered the course of events. The prudential regulator's decision as to whether or not to draw to the attention of Equitable their concerns about Equitable's letter of 1 February 2000 to policyholders was fundamentally a matter of judgment. I do not consider that the FSA's judgment in this respect was wholly unreasonable.

197. As for the prudential regulator's decision not to share the letter with their conduct of business colleagues, I note that the latter had in fact received a copy of the letter via another route and had decided independently that no action was required on it. The conduct of business regulators are not within my jurisdiction and it is not therefore open to me to comment on their actions or inaction. I simply note, therefore, at this point officer J's comments (see paragraph 143) that it had not been clear that the letter was a PIA issue since it was not part of the sales process, although it was intended to inform policyholders. That reinforces the suggestion of a possible gap in the regulatory framework (see paragraph 186) in relation to post-sales information to policyholders which the prudential regulator, as lead regulator for Equitable, might have been more proactive in seeking to resolve. That said, I do not see that, had they done so, that would have influenced these events in any significant manner.

198. I note also that the prudential division did not query the annual bonus of 5% that Equitable declared (in March 2000) for 1999, or the fact that their company accounts for that year included prudent provision of only £200m for GAR options. This was in contrast to the considerable wranglings FSA had had with Equitable around these two issues the previous year. I can only assume that this was because the company accounts were not usually subject to FSA review and the regulatory returns contained a provision of £1.6bn for GAR options (before reinsurance and resilience). Having accepted that the reinsurance would cover any additional GAR liabilities which might arise, FSA considered that to be a sufficiently

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broad safety net, certainly in respect of the reserving requirements. As for the 5% annual bonus, I note Equitable's view (in their report published on 22 March 2000) that no further reduction in bonus payment would be appropriate. This was in essence a commercial decision (a lower rate would have made them less competitive) and entirely in line with Equitable's standard practice of distributing surpluses. It seems to me that, if FSA had challenged them, Equitable could have argued that, given their well-publicised commitment to this approach and to not building up substantial free reserves, reducing the bonus further would not be in line with their policyholders' reasonable expectations. Whilst I can see, with the benefit of hindsight, that that might have been an opportunity for the prudential regulator to flag up with Equitable that it would be prudent for Equitable to build up some further reserves, given that they faced an uncertain future following the adverse Court of Appeal judgment and pending that of the House of Lords, in light of the circumstances at the time, I do not see FSA's decision not to press that particular matter at that point as unreasonable.

Should FSA have predicted the House of Lords' judgment?

199. It would not be accurate to say that FSA were taken totally by surprise by the House of Lords' judgment. As the relevant Director said (see paragraph 150), the ruling was unexpected but not unanticipated. FSA had featured it as part of their original scenario planning. However, the fact that it might go significantly further than the Court of Appeal judgment and rule out ring-fencing, was considered as a real probability only late in the day. As the Director commented, FSA did not consider that the eventual outcome was sufficiently likely for the regulator to act as if it would be the likely outcome. I do not see that in itself as a sign of poor judgment on FSA's part because the House of Lords' judgment effectively went against much accepted actuarial thinking and practice throughout the insurance industry and did not address the broader issue of the reasonable expectations of **all** policyholders, as required to be taken into account by the regulators. The fact that FSA's own legal advisers had asked whether ring-fencing could arguably be contrary to GAR policyholders' reasonable expectations (see Appendix C, 2 March 2000) might have alerted the prudential division to the possibility that the legal view of the position might differ from the view of the actuarial profession. Nevertheless, I do not see that earlier recognition of that as a clear probability would have influenced FSA's subsequent actions in any way.

200. What, if anything, should the prudential regulator have done differently in this period and would it have changed things markedly? Essentially, as officer H said (see paragraph 138), the prudential regulator's role in relation to the court case was to prepare for the various possible outcomes, not to predict what would happen. FSA's managing director also underlined the fact (see paragraph 155) that it was not for the prudential regulator to tell the company what action they should take. What they did have to do was to monitor Equitable's own scenario planning and ensure that they had assessed all the possible outcomes and the urgency with which they would need to respond. The prudential regulator also had to check that the actions proposed did not contravene statutory requirements or pose a serious risk to policyholders.

201. I cannot see that, if the prudential regulator had revisited their scenario planning two weeks earlier, when they received the first real indication that Equitable might lose in the Lords, it would have influenced events. It might be argued that they could have warned their conduct of business colleagues at that point, so that they could monitor more closely what Equitable were saying to potential (and indeed current) policyholders. However, given the conduct of business regulator's views on these events (see paragraphs 120 and 121), I am not convinced that they would have acted any differently, had the prudential regulator done so.

Period from the House of Lords' judgment (20 July 2000) to Equitable's closure to new business (8 December 2000)

Should FSA have allowed Equitable to proceed to sale, or should they have closed them down immediately?

202. This was, once again, a discretionary decision for FSA as prudential regulator. I cannot therefore question it unless it was reached maladministratively. My investigation has shown that, in considering this issue, FSA saw maintaining the value of Equitable as the most important objective and in the best interests of both current and future policyholders. Equitable, for their part, also wanted to try to get the best outcome for their policyholders and in particular wanted to acquire sufficient funding to enable them to repay the seven months of bonus withheld in response to the House of Lords' judgment, and possibly to make a goodwill payment to all policyholders on top of that. The only way that that might realistically have been achievable - if at all - was through a sale.

203. FSA took the view that it was not for them to say that Equitable should not put the company up for sale, as long as a sale looked like an achievable prospect. It was very clear from the evidence given by those officials involved that they strongly believed that closing to new business would have been very damaging to the value of the company and was likely to have eliminated completely the prospect of a sale. That view is supported by the professional advice I have received.

204. It is also true to say that FSA firmly believed - just as Equitable themselves did - that the company would find a buyer relatively easily. Indeed it was the general view of the insurance industry that Equitable would be able to realise their own expectations and be bought at a substantial premium. That view appeared to be well supported when Equitable received a significant number of expressions of interest. I understand also that the process followed the normal sales pattern, with the majority of the initial 15 prospective bidders dropping out over time until there were three serious potential bidders remaining. I have seen no evidence of any earlier

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indication which the prudential regulator should have picked up on during that period that the process might fail.

205. Equitable had also in the meantime (see Appendix C, 11 August 2000) been able to renegotiate the reinsurance agreement to provide financial cover if more than 60% of policyholders took up their GAR option. While this meant that the benefit of the agreement to Equitable was reduced, it did not affect their likely future profits, and helped to restore the regulatory solvency position to a certain extent. I note that FSA also continued to monitor the situation closely by asking Equitable for monthly solvency reports. With the benefit of hindsight perhaps FSA could have asked GAD for a note on the prospects for a successful sale, including any factors which might, singularly or jointly, lead to failure. That could have been done as a part of the scenario planning exercise to have informed FSA's decision as to the reasonableness of Equitable's proposed actions. Had that been completed, it might have alerted the prudential regulator at an earlier stage to specific issues which subsequently turned out to be significant factors in buyers' considerations (such as the difficulties which might be involved in preventing the growth of Equitable's GAR business - the top-ups issue).

206. But would such a piece of work have led the prudential regulator to have insisted on Equitable closing to new business immediately rather than attempting a sale? I do not think that it would. Given the high numbers of potential bidders and Equitable's reputation, I cannot see how FSA would have been able to justify immediate closure. Had they done so, they would have been heavily criticised for taking precipitate action when it was generally believed that the situation was still largely, if not wholly, retrievable.

207. Avoiding such criticism was not, however, the prudential regulators' main consideration (nor indeed should it have been). Their overriding objective (see paragraph 14) was to protect policyholders' interests by ensuring that Equitable remained solvent and able to meet their liabilities. I note in particular the comments of officer J (see paragraph 147) about the need to strike a balance between the interests of new and existing policyholders. He said that the prudential regulator had taken the view that the balance was overwhelmingly in favour of allowing Equitable to continue writing new business. If a sale had taken place as expected then all policyholders - new and old - would have benefited from it. I note also his reminder that, under the conduct of business rules, new policyholders could be compensated if they sustained loss as a result of joining on the basis of misleading information in breach of the relevant PIA rules. That point is, in my view, a key one, because it underlines the clear responsibility placed on companies to ensure that they make explicit the risks involved to potential and existing policyholders (who might be making decisions about possible changes to their current policy arrangements). If those purchasing or changing their policies were made aware of those risks but decided to proceed nevertheless, then that was a matter for them.

208. On balance, and in the light of all the evidence I have seen, I take the view that FSA's contention, that it would have been unreasonable to close Equitable to new business immediately after the ruling as that would simply have precipitated the situation that eventually transpired, and would have given Equitable no chance to save themselves, is a reasonable one.

Was there any other form of intervention that the prudential regulator should have taken at this point?

209. I note that the legislation allowed for a moratorium on new business for two months (see paragraph 32). This option does not appear to have been actively considered. I do not, however, consider that to have been an omission on FSA's part. Given the detailed discussions which had already taken place between FSA and Equitable over the previous year and more, and the scenario planning which had already taken place, I do not see what a delay of two months in putting that plan into action would have been likely to have achieved. As the Director explained (see paragraph 151), given that it had already been agreed that a sale would be the only real way of restoring, at least to some degree, the company's financial position, and therefore in the best interests of Equitable's policyholders, it would not have been sensible to have then imposed a moratorium which would inevitably have reduced the value of the company and potentially even have destroyed all possibility of a sale. In the light of the circumstances at the time, I do not consider that the prudential regulators acted unreasonably in not considering this as an option.

Were FSA wrong to have been so confident that a sale was possible?

210. Given that the prudential regulator's actions were significantly influenced by their belief that a sale would be achieved (not least that they allowed Equitable to remain open to new business on that ground), I turn now to the fundamental question of whether that was a reasonable assumption on their part. I understand that it was well known that Equitable had been approached by potential buyers several times in the past (see paragraph 151 - indeed the chronology also shows that in March 1999 they were approached by another mutual company seeking a merger). The very fact that so many potential bidders expressed an interest, and that three went on to have detailed discussions lasting several weeks, indicates to me that by no means could it be argued that FSA should have been expected to have realised at the outset that a sale was unlikely. I appreciate that FSA were, initially at least, perhaps somewhat more alert than prospective buyers to issues which might potentially raise difficulties (such as the top-ups issue which I deal with below). That said, the fact that the Society did not maintain a substantial reserve of free assets, which was Equitable's main weakness, was also, as I have already said, paradoxically one of their major marketing points, and following the high profile court case, the company's predicament with regard to their with-profits fund was also very well known. The fact of the matter was that Equitable's main selling points were their sales force, their information technology and administration systems and, significantly, their clientèle. The company's financial strength had never been a positive factor; on the contrary the weakness was by design, and was seen by them as a

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virtue in helping to ward off prospective predators.

211. The prudential regulator was however, as I have already indicated, aware of one factor which was not initially common knowledge, which was the difficulty in capping growth in Equitable's GAR business (the top-ups issue - see paragraph 185). The Treasury briefing to the then Economic Secretary on 6 December 2000 suggested that that was the main reason a sale had not taken place (see paragraph 100). If that was so, then should the prudential regulator have recognised that as a potential show-stopper from the start of the sales process?

212. I note the relevant Director's explanation (see paragraph 153) as to why it would be more accurate to describe the potential liabilities arising at that time from top-up payments into GAR policies as unquantifiable, rather than unlimited. Further, given that the serious bidders carried on in the sales process for some time after they had become aware of the top-ups issue, I also accept the Director's contention (see paragraph 159) that, while top-ups were a highly significant factor to potential purchasers, they were not in isolation a deal-killer. Equitable had addressed the issue in a paper for their Board, which they forwarded to the prudential regulator on 20 April 1999. In that paper, they had considered one method of restricting the potential growth in GAR business through the use of certain policy restrictions, but had determined that that would not resolve the matter. Potential bidders had similarly spent a good deal of time formulating workable plans for how to cap the liability and, according to the Director, had eventually succeeded. Nevertheless they decided not to proceed to make a formal bid for Equitable.

213. I have seen from the papers that it was a combination of factors that caused the withdrawals from the bidding process, not all of which were related to Equitable's financial state. The companies' own portfolios and other business plans (such as the introduction of stakeholder pensions), as well as a growing pessimism about the potential for future growth in the life industry, together with then current stock-market trends, were all relevant factors contributing to those decisions. In all the circumstances I do not consider that it was unreasonable for the FSA to have taken the view that a sale was likely to be achieved.

But should the prudential regulator have stopped Equitable advertising as they did?

214. The position as the prudential regulator saw it was that responsibility for the management of Equitable and their business was primarily a matter for Equitable's Board. They had no powers to require Equitable to submit their advertising proposals to the prudential regulator in advance. Indeed the position as I understand it was that the prudential division could formally intervene only if they believed that the advertisements were likely to raise expectations for policyholders which Equitable would be unable to meet. They could then require Equitable to demonstrate that they had sufficient reserves to meet those expectations. I note that the conduct of business regulators seem to have recognised a role for themselves here and were also monitoring the position (see Appendix C, 27 October 2000), although they appear subsequently to have had some doubts about their remit in this regard, as evidenced in the prudential division director's briefing to the FSA Chairman on 6 November 2000. What is also clear, however, is that the advertising campaign that Equitable launched at this time was considered by many - including some relevant media financial commentators - to be lacking in balance and there were some complaints to FSA. The prudential regulator did actively consider those complaints (having consulted conduct of business colleagues on 4 October 2000) and whether there were any steps which they could take, but concluded (on 3 November 2000) that they could not reasonably require Equitable to stop advertising while there was still a realistic chance of a sale. I note further that the Treasury were also concerned about this and contacted FSA to ask if it was acceptable for Equitable to continue advertising in the way that they were. The Treasury clearly accepted FSA's explanation that it was reasonable for Equitable to expect to sell the business as a going concern and therefore to maintain their market presence in order to underpin their prospects for a successful sale.

215. Nevertheless, the prudential division did contact Equitable about the advertisements (on both 8 and 14 November 2000) and Equitable subsequently withdrew their new advertising campaign. As FSA were to explain to the Tripartite Standing Committee on 6 December 2000, it was not clear whether it was the prudential regulator's action that had caused Equitable to do so, or whether Equitable had made that decision in the light of the adverse press comments that had been made about the campaign. On balance, it seems to me that the prudential regulator did give this matter proper consideration but decided that, as Equitable were still meeting all the prudential regulatory requirements and any intervention could have made the position for policyholders worse (in that it might have impacted on the prospects for a successful sale), they had insufficient grounds for formal intervention. They decided instead to bring informal pressure to bear on Equitable. That was a discretionary decision on their part which, given the circumstances at the time, I do not consider to have been unreasonable.

Should the prudential regulator have required Equitable to put a 'health warning' on their products or advertising once concerns had been raised about Equitable's solvency position (November 1998), and particularly after the House of Lords' judgment?

216. It is quite clear from my investigation that the prudential division took the firm view that it was not reasonable to allow Equitable to continue trading, but then to require them to disclose to potential policyholders that there were concerns about the company's solvency, such that Equitable should not be viewed as a good investment. As they saw it, there was no half-way house; either the company was authorised to conduct insurance business or it was not. I accept that argument; particularly as intervention of the kind suggested, that is a 'health warning' on the product, might of itself have helped to push the company towards the very situation which the regulator was seeking to help them avoid, namely

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regulatory insolvency. In addition, by discouraging new business, such a warning could impact adversely on the returns that policyholders could otherwise expect. There also seems little doubt that requiring a special disclosure of that nature after Equitable had decided to seek a buyer would have affected the prospects of a sale, or at the very least the price a buyer might be prepared to pay. That in turn would undoubtedly have left the prudential regulator open to accusations of having torpedoed the sales process, and also to legal challenge by Equitable. In light of all that, I do not consider FSA's decision not to require Equitable to make such a disclosure to have been maladministrative.

Did the FSA as prudential regulator keep the conduct of business regulator adequately informed of Equitable's position during this period? Was there any other action which the FSA as prudential regulator should have taken at this time?

217. I note officer H's comments (see paragraph 137) that the prudential regulator recognised that they had to have regard to the risks to new investors, by requiring Equitable to close to new business if it was not, and had no immediate prospect of becoming, financially sound or meeting policyholders' reasonable expectations. However, the main concern for new investors would be if they were personally misled as to the state of the company - and that was in her view clearly a conduct of business, rather than a prudential matter.

218. I accept that, until the prospect of a sale fell through, the prudential regulator was unlikely to have had sufficient grounds for formal intervention on their own part, and I note that Equitable had assured them (see Appendix C, 1 December 2000) that the sales force had been adequately briefed and instructed to advise potential policyholders of the Society's circumstances prior to sale.

219. That left the question of whether the prudential division ensured that they had made their conduct of business colleagues sufficiently aware of the financial difficulties which Equitable were facing, in order that they could reach an informed view as to what action would be appropriate on their part. I recognise that the prudential division might have been reluctant to stray too far into their conduct of business colleagues' territory in this respect. I have considered, nonetheless, whether the prudential division should have impressed more strongly on their conduct of business colleagues the need for potential new policyholders to be reminded that there was a caveat on Equitable's future health, should a sale not be achieved. With the benefit of hindsight it is easy for me to say that they **could** have done so. But I do not feel able to say that any prudential regulator acting reasonably **should** have done so; and overall I am satisfied that the prudential division kept the conduct of business regulator adequately informed of Equitable's position.

220. I am also mindful of the likely consequences had the prudential regulator been more proactive and insistent on this point. In light of the evidence given by conduct of business staff (particularly officers D and E - the then head of the conduct of business division and the relevant director), that where a firm had not breached the regulatory solvency margin, there would be no grounds on which the conduct of business regulator could require them to make a special disclosure as to their overall financial position on top of the disclosures a company were required to make under PIA rules, I cannot say that that would have made any difference. It seems very clear to me from officer D's comment that the conduct of business division would not have expected their prudential colleagues at that time to have alerted them until the statutory solvency margin had been breached (see paragraph 119), and their comments when consulted about the advertising (see Appendix C, 4 October 2000), lead me to believe that they would not have considered a 'potential future regulatory insolvency' sufficient ground under the PIA rules for them to intervene. As the conduct of business regulators are outside my jurisdiction, I cannot comment on whether or not that attitude was an appropriate one for them to take.

Was it reasonable for FSA to have recommended agreement to the section 68 application which Equitable submitted in June 2000 for a future profits implicit item of £1.1bn to use in their year 2000 returns?

221. The prudential division's recommendation to the Treasury on this was, as usual, based on the advice they had received from GAD, their professional advisers. That advice, however, predated the House of Lords' judgment. I have seen no contemporary evidence that GAD reconfirmed that the earlier advice remained valid after the judgment, but I accept the accounts of GAD and FSA officers (see paragraphs 125 and 132) that they did so. In the event, given that these items are largely based on conservative estimates of returns on existing business, I can see why FSA's prudential division felt that the House of Lords' judgment did not significantly change the position (see Appendix C, 1 September 2000). That said, the application effectively went through the Insurance Supervisory Committee without debate and I note that the Committee did not feel the need to discuss it further when invited by the chairman on 11 September 2000 (see paragraph 88). Given Equitable's by then obviously precarious position, I considered whether that application should have attracted closer scrutiny. I concluded, however, as before (see paragraph 177) that, given that the item was allowed under the regulations and that it fell well within the margins for which Equitable could have applied, it is difficult to see how the prudential regulator could have reasonably recommended refusal. If they had, Equitable would have been well within their rights to have challenged such a decision. Furthermore, given that the item in question was for use in the 2000 regulatory returns (due in June 2001) and did not therefore come into use until after the sales process had ended and Equitable had been closed to new business, I do not see that, had the prudential regulator scrutinised the application more closely, it would have influenced events in the period under investigation.

What of the "*deep-seated oversight*" to which the Treasury briefing referred?

222. That remark was made in a briefing note from a Treasury official to the Economic Secretary on 6 December 2000 (see paragraph 100). The briefing suggested that the oversight was in failing to ensure that Equitable had

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proper risk management processes in place, but that this had become highly significant only after the House of Lords' judgment in July 2000. It is evident from the interviews my staff conducted (see paragraphs 106, 115, 148) that there are differing views as to exactly what was meant by that comment and how informed a view it was. Given the extensive level of contact that the prudential regulator and their professional advisers had had with Equitable throughout the period under investigation, particularly in seeking to ensure that Equitable had sufficient reserves in place to protect their policyholders against the risk that they might not be able to pay valid claims, it is not entirely clear to me either what was meant by that remark. If one accepts officer A's interpretation (see paragraph 106), it was effectively an observation that prudential regulation was not as demanding as other financial regulation. As it was the Treasury's responsibility, having contracted out their prudential regulatory functions to FSA, to monitor FSA's performance in respect of those duties, and the Treasury had apparently had almost daily contact with FSA (see paragraphs 104 and 111), then if this was intended to be a comment on the performance of the regulators rather than on the regulatory framework, I would have expected the Treasury to have raised this with FSA as an issue before. Indeed I note that the then Treasury director of the financial sector said (see paragraph 111) that they had been satisfied that the prudential supervision had continued to be carried out as envisaged under the Contracting Out Order. I do not therefore consider that remark to have been a considered and informed Treasury view of events.

223. Nevertheless, the comment does serve to underline the fact that the view taken of the prudential regulator's actions will depend in large part on what is expected of their approach. It was clear from FSA's agreement with the Treasury setting out key tasks (see paragraph 17) that there was no expectation that there would be a major change in the way in which prudential supervision was conducted during the run-up to FSA taking on the overall regulation of the sector. The regulatory role was seen primarily as a monitoring one, and was based largely on scrutiny of financial returns (with GAD's support). It was therefore heavily reliant on companies providing accurate and comprehensive information, and it was basically reactive.

224. I note officer A's comment that, with the benefit of hindsight, it had become evident that Equitable's assessment of their own position had been superficial (see paragraph 108). As a result, despite all the exchanges the prudential division and their professional advisers had had with Equitable over time, FSA had not appreciated the extent of Equitable's problems until they had become apparent during the bidding process, when their accounts had been opened up to significant and detailed scrutiny. However, I note that that was a far more detailed and in-depth scrutiny than that which would, or indeed could, usually be carried out by the prudential regulator. (I can make no comment on the professional advice (from GAD) that the prudential regulator received in respect of Equitable's financial situation, as GAD and their actions are outside my jurisdiction.) The detailed chronology clearly demonstrates that FSA did press Equitable very hard on a number of issues. It is also clear that, for example on the question of reserving for GAR liabilities, Equitable thought that the regulator was being unreasonable and requiring them to adopt what they saw as a "*wildly prudent*" approach that did not sit well with the whole ethos of their company (I note that they even complained to the then Economic Secretary to that effect and threatened judicial review). Indeed the actuarial opinion I have received (see paragraph 158) suggests that FSA may have been requiring the whole industry, Equitable included, to adopt an approach to reserving that was significantly more prudent than the industry itself believed was necessary. Despite that, FSA maintained a strong stance and made it quite clear to Equitable that they would intervene formally if Equitable did not comply.

225. My investigation has also revealed that throughout the relevant period Equitable received a significantly greater proportion of the prudential regulator's attention than many - indeed if not all - other insurance companies. I note officer J's comment (see paragraph 142) that he could not recall the regulator having ever gone so far in seeking to influence a company's bonus decision as they had done in Equitable's case. Such was the level of contact that it led to Equitable being chosen as an early candidate for the new technique of co-ordinated risk-based supervision (under the lead supervision arrangements).

226. I note also FSA's view, supported by their legal advice, that under the prudential regulatory framework that then existed, they could act formally only if a company took action which would breach the statutory rules; and that otherwise, their role was to help identify emerging problems and issues, and to work with the company in question to get them through that and back to a sound financial base. It was not the prudential regulator's role to make companies' decisions for them (which might be viewed as the regulator acting as a 'shadow director'), but to ensure that companies were aware of how the regulator would respond to decisions the company might make. I note also that the agreement under which FSA operated (see paragraph 11) made it explicit that their role was **not** to seek to achieve 100% success in avoiding company failure; it was recognised that this was neither realistic nor necessarily desirable. FSA's aim was to minimise, but not eliminate the risk of company failure by identifying early signs of trouble and taking preventive action. Given the regulatory framework within which the prudential regulator was then working, and the legal advice that they received about their powers of intervention, I do not consider that that approach was an unreasonable one for them to have taken.

What of the Treasury's responsibility throughout the whole affair?

227. I was concerned from the comments made in interview to my officers that the Treasury might have taken the stance that, in contracting out this area of work to FSA, they had thereby delegated all responsibility for

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prudential regulation. I noted in particular the views expressed by officer B (see paragraphs 110 and 112) that, as all staff with expertise had transferred to FSA, the Treasury could not query their supervisory judgment; they simply needed to know that prudential supervision was being carried out as before. I accepted that it would not have been appropriate for the Treasury to duplicate FSA's own activities or to seek to substitute their own judgment for FSA's. Nevertheless, I could not see how it would be possible for them to fulfil their own responsibilities in this respect unless they had maintained at least some in-house expertise, sufficient to act as an 'intelligent customer' in relation to monitoring FSA's performance under the service level agreement.

228. I was unable to establish the position from the Treasury's own papers because there was little documentary evidence of any contact with FSA during the relevant period. I noted that several officers referred to almost daily contact on prudential matters, both in terms of e-mails and telephone calls, but said that they did not keep records of these (see paragraphs 104 and 111). The only firm evidence of monitoring of FSA's performance that I found was that carried out through the quarterly meetings. I note that even then there seemed to be conflicting views as to the purpose of those meetings. The Treasury officers (see paragraphs 104 and 111) said that they were to discuss matters of significant concern or which might pose a threat to the insurance industry, whereas officer J, in explaining why Equitable did not feature on the agenda in March and June 2000 (see paragraph 144), suggested that the purpose of the meetings was to raise matters that would otherwise have gone unreported (on the grounds, I can only assume, that they were of lesser significance).

229. As it was the Treasury's duty to intervene if they believed the approach being taken by FSA to prudential regulation, and specifically to the Equitable issue, was inappropriate, I asked the Permanent Secretary to explain how the Treasury had carried out their monitoring responsibilities. He explained that the Treasury's policy was that the system of regulation in place under the contracting-out arrangements should anticipate, so far as was possible, the coming into force of the new Financial Services Management Act regime. The retention of significant numbers of staff with regulatory expertise within the Treasury would have prevented that. Nevertheless, the relevant staff in the Treasury at the time in question had many years' experience of financial services work, indeed one of the key Treasury officers had transferred to the Treasury from DTI along with responsibility for prudential regulation in January 1998 (paragraph 11). It could not therefore be argued that those officers did not have the necessary expertise to act as an 'intelligent customer'. However, their role had become more 'arms-length' in that they would only seek to intervene, or question how FSA were carrying out their functions, if it seemed to them that a matter was novel, unusual or particularly contentious, that is something outside their normal framework. The Permanent Secretary went on to say that he accepted that the lack of contemporaneous records had made it difficult to demonstrate the monitoring action being taken by the Treasury and the regular contact that there had been with FSA throughout this period. He said that the Treasury were currently reviewing their record-keeping practices. He added that they had also agreed with FSA that they would hold quarterly meetings, rather than receive quarterly written reports (as required under the service level agreement).

230. One area where my officers did find evidence of contact was in relation to section 68 applications, although it was unclear what level of scrutiny these were given. The Treasury officers (see paragraphs 104 and 114) insisted that these were not simply rubber-stamped but were looked at carefully. While I have seen no direct evidence to support that, I have no reasons to doubt the officers' accounts. Overall, and in light of the Permanent Secretary's explanations, I am satisfied that the Treasury fulfilled their responsibilities in respect of prudential regulation during the period under investigation.

Overview

231. The events preceding the closure of Equitable to new business raised a fundamental question as to the role of the prudential regulator and where the balance of responsibility lies in terms of a company's management of its financial affairs. There were a number of different bodies which all had duties and responsibilities in this respect, namely the Board and managers of the company, their appointed actuaries, their auditors, and of course the regulators. The actions and decisions of all those other parties would have contributed to a greater or lesser extent to what happened. It is not possible, given the limits on my jurisdiction, for me to reach a considered and balanced view of the significance of each of those contributions simply by looking at one constituent part. Nor is it for me to determine where the balance of responsibility should lie between those bodies for what happened in the case of Equitable. I am only able to consider the actions taken by the prudential regulator.

232. Throughout this whole period FSA acting as prudential regulator on behalf of the Treasury constantly had to assess and reassess whether formal regulatory intervention was warranted, in particular whether they had sufficient grounds for intervention. Given that such intervention was likely to have a significant impact on Equitable's future profitability and even viability, could therefore impact adversely on policyholders, and would probably provoke legal challenge, it was clearly not action to be taken lightly.

233. I am satisfied from my investigation that FSA carefully monitored Equitable's regulatory solvency throughout this period, and that at no time was Equitable's financial position such that they had breached the regulatory solvency requirements. Another possible ground for intervention by FSA was if they believed that Equitable were unable to meet policyholders' reasonable expectations. I am satisfied that it would not have been appropriate for them to have taken a decision on intervention in respect of Equitable's differential terminal bonus policy while that matter was before the courts.

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However, the position changed dramatically once that process had concluded adversely for Equitable. FSA then had to reach a difficult judgment as to whether to close Equitable to new business or let them try to sell the company as a going concern. Given that the regulator's primary objective is the protection of policyholders' interests (see paragraph 15), and that FSA believed that to allow Equitable to put themselves on the market would at least enable Equitable to try to get the best outcome for all policyholders, I cannot say that their decision not to intervene by requiring Equitable to close to new business was outside the bounds of reasonableness. I should, perhaps, add that, had FSA intervened formally at that stage, when it was strongly believed that a successful sale (which might have enabled Equitable to have worked their way through their then current difficulties) was virtually certain, I am satisfied that that would have prompted a public outcry on the grounds that the prudential regulator had severely misjudged the situation and that their intervention had been inappropriate. I cannot therefore say, on the basis of the evidence I have seen, that any of the decisions the prudential regulator reached in respect of the exercise of their formal intervention powers were unreasonable or fundamentally flawed such that I would consider them to be maladministrative.

234. Whilst I am satisfied that the judgments made by the prudential regulator were not maladministrative, with the benefit of hindsight, I have identified in my report a number of occasions when FSA, in their role as prudential regulator, might have done things differently. There were, for example, times when FSA might have been prompted to delve more deeply into aspects of Equitable's financial situation, which might have given them a more realistic view of the problems Equitable were facing and of the likelihood of a sale. But I cannot say, if they had been more proactive in those areas and reached a more informed position earlier, that FSA would have reached different decisions about awaiting the outcome of the legal process before deciding to act, or on whether to allow Equitable at least to attempt a sale. From the evidence I have seen I am not persuaded that the failure to achieve a sale was based wholly or mainly on factors relating to Equitable's financial position which the regulator should have unearthed at an earlier stage. FSA's papers indicated that the potential buyers withdrew for a much broader combination of reasons, including commercial considerations and a recognition of the growing difficulties facing the life industry in the face of a continuing and significant downturn in the investment markets.

235. These events also highlighted a number of areas of concern relating to the regulatory systems and framework. I note in particular the apparent limits on the information required to be disclosed in the regulatory returns, which seemingly allowed the extent of GAR liabilities to go unrecognised for so long; and the accepted use of future profits implicit items in the regulatory returns (as laid down in the EU Life Directive) to offset liabilities. Those were, however, lawful actuarial and accounting practices within the contemporary regulatory system within which FSA did not always have powers to intervene, and which are in any event, outside my remit. Nevertheless, I note that those and other perceived weaknesses in the systems and framework are being addressed, as FSA's response to the Baird recommendations demonstrates (see Appendix B).

Mr P's complaint

236. What of Mr P and others like him, who contend that FSA's shortcomings meant that potential investors were unable to make fully informed decisions when purchasing new policies or annuities? I have found that the prudential regulator did consider what action they could take in the light of the potentially misleading nature of Equitable's 1997 returns (see paragraph 170), and that they pressed Equitable to adopt measures to improve their regulatory solvency position. As I have already made clear, the responsibility for what individual potential investors were actually told when purchasing new policies or annuities was not a matter for the prudential regulator. This was a responsibility set primarily on the company themselves and was a matter for the conduct of business regulator to police under the relevant PIA rules. Additionally, given all the publicity surrounding Equitable's high profile court case and their subsequent decision to put the company up for sale, I would have expected potential investors to have sought independent financial advice before investing in Equitable.

237. As for the prudential regulator, as I understand it, the only way in which that regulator could otherwise have helped to shape the views of potential investors as to whether or not to invest in Equitable (short of closing Equitable fully or to new business for a period of two months or more - and I have explained why FSA's decision not to do that was not in my view unreasonable) was by putting greater pressure on Equitable to present their situation in a more balanced and measured way. They might have considered requiring Equitable to put a 'health warning' on their products, but as I have indicated in paragraph 216 above, it was FSA's view that that was not reasonable so long as the company remained authorised to conduct business; and such action was likely, in any case, to have affected existing policyholders' reasonable expectations (by discouraging new investment) and to have had the same negative effects as closure on the company's saleability. What I can say is that, on the basis of the limited evidence I have seen (given that Equitable themselves are outside my remit and I have not examined their papers) I have found nothing to suggest that Equitable would have been persuaded by the prudential regulator to introduce warnings sufficient to deter potential new investors like Mr P. In light of that, and of the fact that I have not found that FSA were maladministrative in their role as prudential regulator, I do not uphold his complaint.

Conclusion

238. Whilst I have identified several things which FSA in their role as prudential regulator might have done differently, I am not persuaded that the decisions that they took were unreasonable, or that they failed to carry out their regulatory duties appropriately. Nor am I persuaded that any action or inaction on FSA's part

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significantly influenced the outcome of these events. I can fully recognise the outrage that Mr P and others in his position clearly feel, that a life assurance company of Equitable's former standing and reputation should, in the course of a relatively short period, reach a position of having to close to new business and significantly cut policy and annuity values, and the consequent significant financial loss policyholders and annuitants have suffered. I very much sympathise with those policyholders and annuitants in respect of the financial difficulties in which they now find themselves as a result. Nevertheless, I am satisfied that the actions of FSA, acting as prudential regulator on the Treasury's behalf, were not maladministrative and cannot be said to have caused the injustice, whether by way of financial loss or otherwise, which Mr P alleges.

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Appendix A

Legal stages in an insurer's failure

(i) Cover for solvency margin above EC Directive minima, but financial condition is a cause for regulatory concern, which raises the need to consider exercising intervention powers under section 37 Insurance Companies Act 1982 (ICA);

(ii) breach of solvency margin i.e. the required minimum margin (RMM) which under section 32(4)(a) ICA would require the insurer if requested by its regulator to submit a plan for the restoration of a sound financial position;

(iii) breach of Directive minimum guarantee fund (MGF). Regulation 22 of the Insurance Companies Regulations 1994 provided that in the case of Equitable the MGF should be one third of the RMM. If the MGF was breached, section 33(1) ICA required the insurer if requested by its regulator to submit a short-term financial scheme;

(iv) anticipated insolvency under non ICA legislation (e.g. the Companies Act 1985) i.e. there is a risk of it no longer having any surplus assets in excess of its liabilities;

(v) implementation of reorganisation measurers short of winding-up, for example, provisional liquidation or a section 425 scheme of arrangement (noting that (v) may occur before and prevent (iv)); and

(vi) winding-up.

Appendix B

Summary of FSA's responses to the recommendations made in the Baird Report

Following the closure of Equitable to new business on 8 December 2000 FSA commissioned their then Head of Internal Audit, Mr Ronnie Baird, to lead an internal review of their regulation of Equitable between 1 January 1999 and 8 December 2000 with a view to identifying lessons for the future. The team's subsequent report (the Baird report) was published by order of the House of Commons on 16 October 2001. Chapter 7 of the Baird report included a number of recommendations with commentary. This appendix lists those recommendations and summarises the actions FSA say they have taken since then. The summary responses to the Baird recommendations are drawn primarily from FSA's progress report of October 2002 "The future regulation of insurance", reporting work led by FSA's John Tiner (the Tiner report) and include other recent material provided by FSA. The paragraph numbers refer to the Baird report.

The Baird report **recommended that**:

7.2 Solvency standards
The current framework needs to be restructured so that the required minimum capital reflects all the risks in the business.
FSA say they will introduce, in 2004, a new risk-based approach to the calculation of capital for life insurers writing with-profits business. They say that consultation on this will take place in the summer.

7.2.1 Guarantees and options within policies
Financial guarantees and onerous options in life insurance policies should be valued stochastically and consistently with traded option prices in the market.
FSA say this will be part of the new risk-based approach to capital planned for 2004. In the meantime, FSA say they are prepared to anticipate some elements of the new approach such as stochastic modelling in the valuation of guarantees, provided firms can demonstrate that this does not create undue risks for their policyholders. They say that a number of firms have done so.

7.2.2 Future profits implicit items
The exercise of discretion over the use of implicit items should be reviewed.
FSA say that they have now given guidance clarifying their criteria for granting waivers to life insurers and friendly societies seeking to include implicit items in their solvency margin calculations. Future profits implicit items will no longer be able to be used in solvency margin calculations from 2009. In the meantime, the amount of any implicit item waivers may be limited by reference to the realistic solvency position.

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7.2.3 Financial reinsurance

A review [should] be undertaken of the extent to which the financial strength of the industry is eroded by the amount of such financial reinsurance in place.

FSA have reviewed and consulted upon a new regulatory approach to insurance firms' use of financial engineering and say they will introduce guidance on how firms should conduct such business.

Full disclosure of [financial reinsurance] arrangements, including the material contingencies to which they are subject, should be made in the regulatory returns.

FSA say that their consultation paper (CP144) proposed clearer, and more directly comparable, presentation of information on such financial engineering to be included in the regulatory returns. FSA say that following the conclusion of this consultation, regulatory reporting for life insurers has been enhanced. There is additional disclosure of financial reinsurance and other financial engineering.

7.2.4 Control levels

The regulator [should] review the possibility of introducing multiple control levels as a basis for triggering proportionate regulatory action.

FSA have consulted on how individual capital adequacy standards for firms might be set and say they will consult on how this approach might be applied to insurance firms (including where there are special concerns about a particular firm or firms). FSA say there will be further consultation this summer.

7.3 The role of the appointed actuary

Appointed actuaries should be subject to independent external review. This may be carried out by FSA or by independent firms, but must be conducted to a level which would provide comfort equivalent to that of an external audit.

FSA say that they have consulted on detailed proposals for the future role of actuaries in life insurers. These include widening the scope of the audit review to cover the aspects of the regulatory return that are currently the responsibility of the appointed actuary. As part of their audit work, the auditors would be required to obtain an opinion from an actuary (who must be independent of the firm), which they would then publish as an annex to their audit opinion. The actuarial work on the valuation of policyholder liabilities would thus be subject to the professional challenge of audit and review by an independent actuary.

7.4 Disclosure

The purpose, content and frequency of the regulatory returns [should] 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 solvency or PRE [policyholders' reasonable expectations] issues.

FSA say that they have committed to a fundamental review of regulatory reporting and that there will be two consultation papers in 2003. Part of this will be more regular and timely reporting to the FSA, covering all aspects of prudential and conduct of business information. This review will also consult on electronic submission of data to the FSA to improve timeliness and efficiency.

FSA say they have consulted on proposals that would require firms carrying on with-profits business to establish and make publicly available the principles and practices of financial management they apply in managing with-profits funds, and to inform policyholders of changes in these. The with-profits review also recommended a number of improvements to the information given to with-profits policyholders in annual statements, the detail of which will be covered in a forthcoming consultation. FSA say they are also seeking views (in DP20) on issues arising from the Sandler Review's recommendations on compulsory disclosure to policyholders of unsmoothed asset shares.

The assessed financial risk must be an integral part of an overall risk assessment which is consistent, and consistently applied, across the FSA.

FSA say they have introduced a new risk assessment framework which they have already applied to all insurance firms except a number of Lloyd's managing agents and low impact firms. This framework includes an assessment of the financial position of the firm and of the potential risks to its soundness from its existing and proposed business. For an insurance firm this will cover its overall regulatory solvency as well as, for example, more detailed analysis of its capital position, reserving, reinsurance arrangements and underwriting results. FSA say they use their specialist actuarial resources or independent skilled persons to provide more expert analysis where appropriate.

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.

Since 1 December 2001, FSA have had substantial powers under the Financial Services and Markets Act (FSMA) to require further information from insurance firms. FSA say they are exercising these powers and in particular have commissioned reports from skilled persons on specific aspects of individual firms' operations. In addition, FSA say they have recently recruited insurance risk specialists to form a central team which is now being actively used as part of the risk review process.

7.5 Industry review

FSA [should] consider the feasibility of producing on a regular basis a review of issues and trends that may pose a regulatory risk to the industry.

FSA published their Financial Risk Outlook in January 2003 and say that this includes a full review of risks affecting the insurance industry. FSA's Insurance Risks Group, chaired by John Tiner, draws together supervisors, actuaries, economists and other specialists to assess emerging consumer and market risks to decide how to deal with them.

7.7 Culture

FSA, in its regulation of the long term insurance industry:

- **where appropriate to do so, [should] 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.**

FSA say that they are using their new statutory powers and risk assessment framework to achieve these aims. Particular improvements include: the identification of insurance risks; the assessment and prioritisation of them; and the use of a regulatory 'toolkit' of measures designed to mitigate risks.

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 FSA's creation of one division, comprising prudential and conduct of business regulators, to deliver integrated supervision of the insurance industry.

FSA say that more effective internal liaison has been achieved, including through the full integration of actuaries and supervisors. This has been further enhanced by the establishment of two groups to co-ordinate insurance issues across the FSA: John Tiner chairs a high level group to ensure that the necessary cultural changes are embedded firmly across all FSA divisions and there is a separate group to identify and discuss emerging risks in the insurance industry.

7.8 Process

Wholly integrated supervision of the insurance industry is being introduced. 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 FSA, but it will not necessarily achieve it.

FSA say they have established a high level group (chaired by John Tiner and which meets monthly) to ensure that the necessary cultural changes are embedded firmly across all FSA divisions.

[When any matter emerges which is of a certain size and scale and/or has potentially significant reputational issues], FSA management [should] 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 comprehensively exchanging all relevant information and managing issues in a consistent and comprehensive way.**

FSA-wide processes for dealing with major event management have now been introduced and steps taken to improve communication and co-ordination between the various divisions with an interest in insurance regulation.

This message [that the market confidence objective does not imply aiming to prevent all collapses or lapses in conduct in the financial system] be reinforced by making it clear to customers that non-intervention or no comment by FSA, where a company's difficulties are attracting press coverage, should not be taken as an endorsement of the company's financial well-being.

FSA say that they take every appropriate opportunity to make this clear and are considering more broadly how consumers might obtain more information about potential problems in firms.

FSA considers what standards of disclosure should apply [when customers are potentially exposed to significant operational risks] and the extent to which these can be codified.

FSA say that this recommendation is being addressed in several strands of work including initiatives to improve: firms' marketing material; firms' understanding of their disclosure obligations; information given to customers at the point of sale; disclosure of how discretion is exercised in with-profits funds; and information given after point of sale.

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Steps [should] be taken to rectify the [lack of effective interaction between the regulator and Enforcement] and, in particular, to ensure that information in the hands of the Enforcement team is made available to the regulator and vice versa in a timely way in order to improve management of the matter and thereby overall consumer protection.

FSA say they have put formal procedures in place to promote timely and effective liaison, and co-ordination, between the insurance supervisors and the Enforcement Division.

As part of the integration of [prudential and conduct of business regulation], FSA takes steps to ensure that responsibilities [relating to customers' interests and communications with customers] are comprehensive and properly co-ordinated and managed.

The supervisors responsible for managing relationships with individual firms now have responsibility for issues relating to both customers' interests and communications with them.

7.9 Tools

FSA give 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 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.

FSA say they have introduced a comprehensive new risk assessment and mitigation framework. In addition FSA say that they have improved their internal processes including developing an internal 'watchlist' of higher risk firms and implementation of FSA-wide processes for dealing with major event management.

In situations where regulators have to have regard for concepts such as PRE [policyholders' reasonable expectations], 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.

FSA say their internal policy and procedural guidelines have been updated to promote consistent interpretation and application of the current regulatory regime and the risk-based approach to regulation.

In particular, [the Baird review team] encourage FSA to carry through to completion its current work on clarifying the meaning of customer interests and PRE.

The concept of policyholders' reasonable expectations has now been replaced by the principle that due regard must be paid to the interest of customers and they must be treated fairly. FSA say their work in this area includes a number of strands relating to firms' responsibility to treat customers fairly before, during and after the point of sale. FSA say they are consulting on proposals to improve the effectiveness of product disclosure at the point of sale for packaged products, including with-profits funds (CP170). FSA have already consulted on a requirement for firms to publish the principles and practices of financial management, which they apply to the management of with-profits funds. FSA say they will also consult on guidance designed to give firms greater clarity on what the obligation to treat customers fairly means as regards with-profits business.

The new approach as set out in the "New Regulator for the New Millennium"* will require consideration to be given by FSA to the level of resources committed to [life insurance regulation] and to the mix of competencies and skills required in order to give effect to the more proactive and interactive approach which is planned.

FSA say they have recruited 35 new insurance supervisors, most from the insurance industry and, in addition, have recruited two senior insurance advisers, both with extensive expertise.

7.10 General

The Baird report concluded that the Equitable case had industry-wide implications but that their terms of reference had only allowed limited insight into FSA's consideration of those. They said that they:

would expect FSA to have progressed such exercises.

FSA say that following the House of Lords' judgment in the Equitable case, they asked firms with GARs to consider whether they were compliant with the judgment and, if not, what they would do or were doing to bring themselves into compliance. For those firms which have been identified as not being compliant, FSA say that they have sought proposals for rectification to compensate those who may have suffered loss. Following the publication of the Warren and Glick Opinions (for the Equitable and the FSA respectively) in 2001, FSA say they issued guidance in early 2002 to all with-profits firms that sold guaranteed annuity business about how firms should assess whether there had been mis-selling and, if so, the financial impact of the cost of the guarantees on non-guaranteed policyholders. Work is continuing to identify any incidences of mis-selling and to resolve with firms how such mis-selling should be rectified.

Further information on the Tiner Report and other matters is available from FSA or their website at **www.fsa.gov.uk.**

* "A New Regulator for the New Millennium" was published by FSA in January 2000.

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Appendix C

Summary of events: C1597/01

1957

According to the Baird and Corley reports, Equitable's first life insurance contracts to include a Guaranteed Annuity Rate (GAR) were sold.

Equitable began to include a GAR option based on a current interest rate of 4% for some pension policies allowing the policyholder on retirement to exchange some or all of the benefits the policy provided for an annuity at a rate guaranteed in the policy.

1971

The Finance Act made it possible for a policyholder to take part of the policy benefit in cash instead of in an annuity.

1975

Equitable increased the interest rate on which the GAR was based from 4% to 7%, where it remained until 1988.

Equitable introduced terminal bonuses for with-profits business; some other companies had already done this.

1988

29/04/88
The Financial Services Act 1986 regulatory regime came into force.

30/06/88
Equitable ceased to offer GARs on new policies.

GAR policies were sold with increased flexibility following introduction of open market options in the legislation of the mid-1980s.

1989

20/03/89
A paper presented to the Faculty and Institute of Actuaries by Equitable's then appointed actuary said: "*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*".

1993

10/93
For the first time Equitable's GARs briefly exceeded then current annuity rates and the guarantee became a valuable benefit to those policyholders whose policies were maturing.

22/12/93
Equitable approved their then appointed actuary's proposal to adopt a differential terminal bonus policy.

1994

01/01/94
Equitable adopted differential terminal bonuses to reduce the advantage GARs would otherwise have conferred on eligible policyholders.

The Personal Investment Authority (PIA) became responsible for conduct of business regulation of PIA member companies.

05/94
Current annuity rates once more exceeded Equitable's GARs (until May 1995).

07/94
Equitable joined PIA.

15/12/94
Equitable applied for the first of an annual series of section 68 orders (paragraph 25) permitting a proportion of future profits to be included as an implicit item in calculating the cover for their solvency margin; the application, which was granted, was for £500m.

1995

24/02/95
A Ministerial statement (made in the context of attributing surpluses accumulating in with-profits funds) set out the concept of policyholders' reasonable expectations and the then regulator's view of the factors which influenced these in respect of the attribution of surpluses in with-profits funds. [These are listed in paragraph 33 of the report.]

05/95
Equitable's GARs began consistently to exceed current annuity rates.

28/06/95
Equitable applied for (and were subsequently granted) a section 68 order in respect of 1995 for £500m.

1996

26/06/96
Equitable applied for (and were subsequently granted) a section 68 order in respect of 1996 for £600m.

11/96
The then prudential regulator (DTI) and GAD visited Equitable for a routine regulatory visit as part of a three yearly cycle of such visits.

1997

01/97
The Faculty and Institute of Actuaries set up a working party to review the GAR option issue and survey the reserving practices of life insurance companies.

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20/05/97
The Government announced plans to reform the structure of financial services supervision. A key aim of the reform was to bring together the various regulatory bodies into a single organisation operating within a single, coherent legislative framework. This resulted in the creation of the Financial Services Authority (FSA). [The resulting legislation was the Financial Services and Markets Act 2000, which came fully into force on 01/12/01.]

c06/97
Current annuity rates began consistently to fall below GARs for companies generally.

30/06/97
Equitable applied for (and were subsequently granted) a section 68 order in respect of 1997 for £700m.

04/08/97
Equitable, through a subsidiary, created bonds to fund a £350m loan subordinated to the rights of policyholders.

19/08/97
DTI granted a further section 68 order which allowed Equitable to take credit for the subordinated loan in their regulatory returns.

26/11/97
DTI told the NHS that there were no points of contention between them as regulators and Equitable. There were no material factors that might influence a NHS decision to appoint Equitable to provide an additional voluntary contributions pension scheme for NHS staff.

30/11/97
The Annuity Guarantees working party of the Faculty and Institute of Actuaries (01/97) considered three possible approaches to reserving for GARs but found that the variation between products and between the approaches of different companies to managing the guarantees was so great that they felt unable to recommend a single approach. They said that not reserving for such guarantees on the grounds that terminal bonus adjustments would be used and were sufficient to cover guarantees in all circumstances [Equitable's then approach] could be viewed as "*unsound*" because no explicit provision was made for an explicit guarantee.

16/12/97
In their scrutiny report on Equitable's 1996 regulatory returns GAD noted that Equitable were highly regarded and the oldest mutual life assurance society in the world. They paid no commission to intermediaries, achieved outstanding business growth, and had a reputation for "*astonishingly low expenses*". About 65% of their liabilities related to with-profits business. Because guaranteed bonuses included credit for a measure of asset appreciation, future bonus declarations seemed vulnerable to any sustained stockmarket downturn. GAD also noted that Equitable had a modest free estate (funds held within an organisation that are not attributable to any particular member or group of members). They raised some questions about the strength of the reserves established, in particular the provisions made for resilience, capital gains tax and pensions mis-selling. GAD reported that the section 68 order for a future profits implicit item granted for 1996 was £600m, £313m of which had been used but was not needed to cover the required minimum margin (paragraph 22). They also noted the existence of the £350m subordinated loan and that Equitable made little use of reinsurance.

GAD gave Equitable a priority 3 rating (paragraph 19); cover for the required minimum margin was 2.53. They commented that they did not consider there were any actual potential solvency problems for Equitable, but it would be desirable for them to hold back more of their emerging surplus by declaring lower guaranteed bonuses. GAD also said that it might be desirable for Equitable to give greater prominence in their literature to their policy of penalising early surrenders in relation to guaranteed bonuses; and it would be desirable for policyholders to be given greater warning about the possible implications for future bonuses of a substantial market setback. (GAD did not question a Zillmer adjustment (paragraph 30) shown in these and subsequent returns until late 2000.) GAD wrote to Equitable about a number of the questions arising from their scrutiny report.

1998

05/01/98
The Treasury took over from DTI responsibility for prudential regulation. The then DTI staff were seconded to Treasury but remained in their previous location, becoming Treasury's insurance division.

13/01/98
Equitable responded to the questions raised in GAD's letter of 16/12/97. They confirmed 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.

16/01/98
GAD told Equitable that the above confirmation did not necessarily cause them any concern. However, the lack of any unutilised free estate brought to prominence the importance of not building up policyholder expectations too far such that it might then be necessary to hold reserves for anticipated final bonus additions.

04/02/98
Equitable told GAD that their bonus statements emphasised that the final bonus element of the current policy value was **not** guaranteed; they were acutely aware of the need not to build up inappropriate expectations.

19/02/98
Equitable's appointed actuary told their Board that a life insurance company had a number of measures available to manage solvency. There was no need to take avoiding action at an early stage merely because a position of

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regulatory difficulty was seen as an outcome of a possible scenario (but one which might well not happen). Provided the regulatory solvency position was kept under regular review, as it was for Equitable, and the implications kept in mind, there was no need to allow regulatory considerations to influence behaviour until it was felt that an unsatisfactory outcome was reasonably likely without some change of direction.

27/02/98
GAD told Equitable they did not intend to imply that they were considering outlawing the type of bonus notice issued by Equitable, but it would be a concern if **any** holders of accumulating with-profit contracts were ever to feel they had been misled. Equitable's manner of operating meant there was not much of a cushion to protect policyholders from the natural effects of future falls in asset values. GAD were confident that Equitable were aware of that.

GAD told Treasury's insurance division that their scrutiny of Equitable's 1996 returns was complete. GAD were basically satisfied with the prudence of the reserving bases (mathematical and resilience) which Equitable were applying. However, the position was very tight because of the way Equitable operated and GAD were accordingly keen to ensure that they should not build up any false expectations for their policyholders, as it would be hard to establish reserves for any greater liabilities.

21/04/98
GAD asked to meet Equitable to discuss bonus methodology, policyholders' expectations and reserving.

29/04/98
Equitable told a policyholder that they held "*the prestigious AA (Excellent)*" rating for financial security from a named private sector rating agency.

28/05/98
Equitable visited GAD to discuss a range of issues, including reserving matters [see entry for 08/06/98 below].

01/06/98
FSA seconded staff, some of whom had previously been PIA employees transferred to FSA, to the PIA to perform conduct of business regulation.

08/06/98
GAD reported to the Treasury's insurance division the outcome of the discussions with Equitable on 28 May. They confirmed that scrutiny of Equitable's regulatory returns for 1996 was closed, and that no strengthening of reserves was needed in relation to accumulating with-profits business. However, they said, they remained concerned that not all policyholders in Equitable and other life companies appreciated what could happen to future bonus declarations if there was a sudden downturn in asset values. The whole industry were relying on a soft landing, so that reductions in future bonuses could be achieved gradually and without trauma.

GAD told Equitable, following the 28/05/98 meeting, that there was little more at that stage to be said or done in relation to reserving. GAD said that Equitable had agreed that great restraint should be exercised in setting guaranteed bonus levels at a time when a large part of investment returns was being derived from capital gains. GAD said that they remained concerned that policyholders might not understand if a time arose when total attaching bonuses (the overall level of bonus payable on a policy) were necessarily cut - although other companies would be likely to disappoint earlier than Equitable.

20/06/98
GAD initiated a survey of the approach of life companies to reserving for guaranteed annuities.

26/06/98
Equitable applied for a section 68 order in respect of 1998 for a future profits implicit item of £850m.

c30/06/98
Equitable submitted their 1997 regulatory returns, which included a future profits implicit item of £371m by the due date. [GAD were scheduled to undertake the initial scrutiny and report the results to the Treasury by the end of August - see 31/08/98.]

29/07/98
Responding to GAD's survey of 20/06/98, Equitable said they had made no explicit provision for GARs in setting resilience or mathematical reserves; their investment policy took no account of the guarantees. Equitable's approach had not been modified by the debate within the actuarial profession on annuity guarantees. The cost of annuity guarantees had been more than adequately covered by the terminal bonus cushion to date for all but a few policies. Policyholders could pay additional premiums to which the guaranteed annuity rate would apply. As the business to which the guaranteed annuities applied aged, the increasing terminal bonus cushion made it increasingly unlikely that guarantees would actually bite [that is, require additional resourcing]. Not all policyholders were advised at retirement that there was a GAR option available to them.

31/07/98
GAD concluded their survey, which suggested that eight companies should be called in for discussions about their practices. Equitable and one other company were notable exceptions to industry practice in not holding substantial reserves to cover GARs, and Equitable seemed to be particularly vulnerable because the relevant business was approaching 30% of their total. (A different eight companies said they used the same differential terminal bonus approach as Equitable.)

08/98
From early August the media began to comment about the costs of guaranteed annuities to insurance companies.

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13/08/98
GAD provided the Treasury's insurance division with a paper discussing the increasing value of GAR options resulting from lower interest rates and lighter mortality (average life-span had increased, with the result that people drew their pensions for longer). They said that companies now faced a significant problem with regard to GAR options, the scale of which GAD were investigating. GAR options existed in large numbers and threatened solvency in many cases and the actual, if not necessarily reasonable, expectation of policyholders in even more cases. There was a risk of them becoming the regulators' problem. The paper asked if varying the terminal bonus according to the cost of the GAR options met policyholders' reasonable expectations. GAD told the Treasury that, in their view, the terminal bonus could be restricted to keep down the cost of a GAR option, depending on the wording of individual policies. This would not however justify a lower reserve as the terminal bonus itself was not reserved for. To the extent that the GAR option applied to the full sum, the full pain had to be borne.

23/08/98
A newspaper article noted that some insurers might not be able to identify which policies contained a guarantee and, as policyholders might not have been aware of their entitlement, some may have received lower pension incomes than their due.

28/08/98
FSA's conduct of business division sent their media relations division and the Treasury's insurance division a memo referring to press comment on difficulties relating to GARs and saying that the matter was outside PIA's scope as the sales had occurred before the Financial Services Act 1986 had come into force. However, as the GAR issue also raised the question of solvency, the Treasury's insurance division were also investigating.

31/08/98
GAD's initial scrutiny report on Equitable's 1997 regulatory returns was due to be sent to the Treasury. [According to FSA, when it was subsequently decided to ask Equitable to submit their 1998 annual regulatory return early - see entry for 07/01/99 - it was decided to hold over the detailed scrutiny of the 1997 annual regulatory return and complete the review of that annual return alongside the detailed scrutiny of the 1998 annual return. That detailed scrutiny was completed in May 1999.]

09/98
GARs in many Equitable policies were by now some 30% above current annuity rates.

FSA's conduct of business division began to receive complaints about Equitable's treatment of GAR options.

01/09/98
GAD gave the Treasury's insurance division advice on company behaviour in relation to GAR options, including when a company should tell a policyholder if a GAR was valuable, which they said PIA should police. They said that the Treasury had a duty to ensure that policyholders' reasonable expectations were met along with other prudential matters. They suggested that the Treasury should circulate a note to all companies saying that avoiding GAR option obligations was unacceptable behaviour. All companies should be asked to report on the procedures in place to ensure that guarantees were included in quotations and the Treasury should use any complaints to trigger a visit to the company to review procedures. GAD concluded that a more proactive course, reviewing companies routinely, would be too resource intensive to be practical and would be open to criticism as a misuse of powers.

03/09/98
The Treasury's insurance division asked GAD for a meeting to discuss the issues raised.

The Treasury's insurance division sent a memorandum to FSA's relevant managing director whose remit included the regulation of insurance, and copied it to the conduct of business director. The Treasury noted recent media interest in GAR options and told the managing director about the GAD survey. They said that they would be considering the implications of the survey results for the fulfilment of policyholders' reasonable expectations. They said that the conduct of business division would have an interest in the extent to which companies were informing policyholders of the existence of GAR options when they came to make choices on retirement. This was an issue where both sets of regulators would need to work closely together to ensure a seamless regulatory approach.

08/09/98
Equitable received legal advice that their differential terminal bonus policy might be open to challenge. (This advice was not shared with the FSA.)

15/09/98
GAD told the Treasury's insurance division that it was reasonable to grant the section 68 order requested by Equitable on 26/06/98. They enclosed a copy of Equitable's reply to their survey dated 29/07/98 and commented that Equitable had a problem with GARs but saw no need to reserve for them as they reduced the terminal bonuses to balance out the additional costs. GAD recommended that the Treasury should explore the subject further by asking Equitable for relevant marketing literature in support of their approach in order to be satisfied that policyholders' reasonable expectations were being met.

17/09/98
Equitable reviewed with Counsel their GAR policy and options.

21/09/98
The Treasury's insurance division asked Equitable for relevant marketing literature or other evidence that their

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approach of reducing terminal bonuses met policyholders' reasonable expectations.

25/09/98
The Treasury granted Equitable's application (of 26/06/98) for a section 68 order for a future profits implicit item of up to £850m.

29/09/98
Equitable told the Treasury's insurance division that they adopted the unusual approach of guaranteeing full value benefits on retirement whenever it occurred. This was the fairer course for all. Equitable said that they recognised that guaranteed annuities could become valuable when interest rates were low. Their terminal bonus practice was intended to achieve equity between those taking benefits in cash or annuity form. The aim was to pass on 'smoothed earnings' achieved over the lifetime of the policy. (This was a way of ensuring that policyholders did not receive unduly high or low benefits as a result of fluctuations in equity values at the time the policy vested.) As terminal bonuses were allotted only at retirement they could vary and were not guaranteed. The presentation of results to clients concentrated on the vast majority who were interested in taking the cash option rather than an annuity. Equitable had first introduced the practice of paying a lower terminal bonus where a GAR option was exercised at the end of 1993; that practice had been disclosed in their returns to DTI each year since. All clients with policies containing GARs had had at least two annual statements describing Equitable's bonus philosophy.

01/10/98
Equitable sent the Treasury's insurance division a copy of a 1980s retirement annuity policy document containing GAR options and a copy of Article 65 from their Articles of Association, which gave directors discretion on awarding bonuses.

02/10/98
The Treasury's insurance division and GAD met Equitable to discuss Equitable's approach to deciding what benefits policyholders with GAR options received and the implications for solvency. The Treasury note of the meeting said that it had been agreed that Equitable would provide a revised assessment of the reserves required for GAR options. GAD and the Treasury would then consider the status of the future profits implicit items concession. Equitable said that their constitution gave them powers to vary terminal bonuses for different cohorts of policyholders. GAD, however, considered that the policy wording was open to interpretation. Equitable said Counsel had advised that they were acting fully within their rights. Equitable added that many of their policies to which GARs applied allowed payment of additional premiums, but that this was not a risk, owing to their treatment of asset shares; they accepted, however, that switches of policies into Equitable were a risk.

GAD said that guarantees should be reserved for whether or not they were biting [that is, where the guaranteed rate was higher than the current annuity rate]. In their view Equitable should look at all their guarantees and options and make appropriate reserves. Equitable objected, saying that that could have severe consequences for them. They were concerned that in the then current climate tougher regulatory controls could tip companies into insolvency. However, Equitable agreed to assess the need to provide reserves for GAR options and to reassess solvency. The Treasury agreed that, if approached, Equitable could say that they "*had responded to the GAD survey ... and they have been in communication with the Treasury with respect to that survey*".

07/10/98
An Equitable policyholder wrote to the PIA Ombudsman complaining that Equitable intended to reduce the bonus payable under his policy if he chose to take an annuity at the guaranteed rate. The letter was copied to the Treasury's insurance division.

09/10/98
GAD told the Treasury's insurance division that companies needed guidance on their joint interpretation of policyholders' reasonable expectations for GAR options. It was GAD's view that policyholders with GAR options could reasonably expect to pay some premium or charge towards the cost, resulting in some reduction of the final bonus that would otherwise be payable. GAD said that they expected to see the cost met first out of any estate held within the fund, then by adjusting the future bonus allocations in the context of policyholders' reasonable expectations, which would be influenced by their policy documents and any representations made by the company.

19/10/98
At the request of the then Economic Secretary, the Treasury's insurance division briefed her on Equitable and their exposure to GARs. The Treasury said that they intended to issue guidance to the industry on handling GAR options in the context of policyholders' reasonable expectations. They explained that meeting the cost of GARs was putting a significant strain on Equitable's finances. As a mutual, Equitable did not have the option of a capital injection from shareholders. It was feasible that they would have to consider some form of de-mutualisation through merger, depending on how serious the financial situation proved to be. They had asked Equitable for more up-to-date information and the Treasury would monitor that and take any action necessary to protect policyholders' interests. Their initial view, on the evidence they had seen, was that Equitable's approach was consistent with the terms of the contracts sold and Equitable were endeavouring to fulfil the reasonable expectations of all their policyholders. They concluded that it was reasonable for policyholders to pay a charge towards the cost of the GAR option, provided this was allowed for in the terms of the contract. They proposed, subject to the then Economic Secretary's approval, shortly to prepare guidance on those lines for the industry. [The brief was not copied to FSA's conduct of business staff.]

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The Treasury's Debt Management Office wrote to the Treasury's insurance division about the possibility of issuing a gilt, including an option designed to cover potential GAR option liabilities, if there were policy reasons making that desirable. They said that the suggestion had been put to them by a clearing bank. The Treasury's insurance division asked GAD for advice.

26/10/98
The Treasury's insurance division received oral legal advice from Treasury Advisory Division (Treasury's legal advisers) on the draft industry guidance.

The Treasury's insurance division sent the then Economic Secretary proposed guidance to the industry on methods the Treasury considered acceptable for meeting the costs of GAR options. These were that policyholders could be expected to pay some charge towards the cost of their guarantees, but that where the full cost could not be recovered from such charges, it might be appropriate to meet the costs from surpluses within policyholders' funds. The note added that Equitable's approach of reducing the terminal bonus had been criticised in the press but was in line with the proposed guidance. It was reasonable that with-profit policyholders, who stood to gain from the sale of contracts containing GARs, should share any associated losses. A response by 30/10/98 was requested. [The draft was copied to GAD but not to FSA's conduct of business division or PIA.]

30/10/98
Equitable told GAD that the GAR would provide a higher level of income in around 30% of retirement cases, but that so far no clients had chosen to take advantage of the GAR. [Note: Equitable's practice of reducing the terminal bonus for policyholders opting for the guaranteed rate would usually negate the benefit of the GAR.] Assuming the worst case scenario would require a reserve of £170m. However, they felt it prudent to reserve on the assumption that 30% of policyholders would exercise the GAR option, which would in itself represent a significant shift in policyholder behaviour. Equitable said that the commercial cost of the guaranteed annuities was highly unlikely to exceed £50m. To assume the most prudent approach (and reserve at £170m) would mean reserving at least three to four times the expected true commercial cost and, probably, a substantially higher multiple than that. Equitable felt that that would be inappropriate.

02/11/98
The Treasury's insurance division told their Debt Management Office that they were monitoring very closely the exposure of companies to the GAR issue. They considered that the bank which had raised the question of a gilt (19/10/98) was somewhat overstating both the size of the problem and the difficulties posed for companies, but concluded that it was early days yet, and they would get back to them if their involvement was thought necessary.

03/11/98
GAD passed Equitable's letter of 30/10/98 the to Treasury's insurance division saying that it was not acceptable for Equitable to rely on the terminal bonus, for which they had made no provision, to meet the cost of the GARs. Equitable had not yet recognised that, nor had they attempted to quantify the reserves on the basis requested at the meeting held on 2/10/98. GAD said that the issue of adequate mathematical reserves was quite separate from that of applying GARs consistently with policyholders' reasonable expectations. Mathematical reserves needed to reflect the **full** value of the GARs; Equitable should reserve on that basis. That was necessary to comply with Regulation 64 of the Insurance Companies Regulations 1994. If Equitable were unable to meet that obligation, then intervention under section 37 or section 11 of the Insurance Companies Act 1982 might be warranted. GAD advised that the Treasury's insurance division should write to Equitable urgently inviting them to a meeting in the next few days to explain how they proposed to fund the mathematical reserves that were required.

c04/11/98
The Treasury's insurance division decided that an urgent meeting with Equitable was required to satisfy themselves that: Equitable were taking a proper view of their liabilities, not only the actuarial issues but also contractual rights; that Equitable had not cherry picked the policy and promotional documents provided so far; and to take a view on whether Equitable's approach was in line with the Insurance Companies Act requirements and more generally accorded with policyholders' reasonable expectations. They noted that it might be necessary for the Treasury to seek Counsel's opinion.

05/11/98
The Treasury's insurance division sent the FSA the draft guidance letter of 26/10/98 on how they expected companies to meet policyholders' reasonable expectations in dealing with GARs and the costs of meeting them. The Treasury drew attention to Equitable's "*controversial policy*" of paying the GAR on the guaranteed sum and not on the terminal bonus. They said that their preliminary view was that Equitable were entitled to do this, but they were seeking further information to test the position further. Their primary concern, however, was over Equitable's ability to reserve adequately for these guarantees. They commented: "*The information received to date is unconvincing and raises serious questions about the company's [regulatory] solvency.*" The Treasury said that they were meeting Equitable again the following week to discuss what further steps they might require Equitable to take.

A copy of this note was sent to the FSA's conduct of business director who endorsed it on to a senior colleague saying "*Are we clear that PIA has no standing in this, because the business was written pre the coming into force of the '86 Act?*" The recipient passed the note to another colleague saying that was also his understanding of the position.

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The Treasury's insurance division wrote to Equitable noting a wide discrepancy between their views on Equitable's approach to reserving for GARs. They said that in accordance with Regulation 64 appropriate mathematical reserves had to be established for the full value of the GARs. Equitable had not even attempted, as requested on 02/10/98, to quantify the reserves on that basis. An urgent meeting, to be held at the Treasury, was required. After that discussion, the Treasury would write again setting out more fully what further steps they might require Equitable to take. The meeting would also offer an opportunity to discuss further the issue of policyholders' reasonable expectations arising from Equitable's treatment of GARs.

06/11/98
FSA's chairman wrote to the director of the Treasury's insurance division to ask for advice about questions which had been put to him about GARs, and Equitable's approach. These included whether Equitable were right in their view that they could fund a guarantee by reducing bonuses or whether that was inappropriate and the regulators should outlaw it; whether there had been a failure of prudential supervision if the with-profits fund could not bear the cost of these guarantees; and what would happen if the funds were not available to pay up except by reducing the size of the fund below a level which actuaries felt was required to deal with other policyholders' reasonable expectations. Would not regulators then be invited to "*pay Peter by robbing Paul*", and how would the decision be made?

A copy of the memo went to the conduct of business division where a manuscript note was made on it, which said that the division did not think these were matters for them.

09/11/98
FSA's managing director told the Treasury's insurance division that in his view it was "*critical*" that they sought further information to test their preliminary view of 05/11/98, that Equitable were entitled to pay the GAR only on the guaranteed sum and not the terminal bonus.

11/11/98
Equitable apologised to the Treasury's insurance division for misinterpreting their request for additional information. They said that the basic additional reserve at 31/12/97, on the basis requested, would have been c£675m; projected to 31/12/98 at a valuation interest rate of 5% the basic additional reserve would have risen to £1,375m. However, it was difficult to assess the impact of future premiums [i.e. of top-up payments] as it would mean scanning the files at the year-end to determine where entitlement to pay further premiums existed (contractually entitlement was lost if a premium was not paid each year).

The Treasury's insurance division asked GAD to suggest what information they might ask Equitable to provide to satisfy themselves of the reasonableness of Equitable's actions in terms of policyholders' reasonable expectations.

12/11/98
An internal minute within FSA's conduct of business division commented on the chairman's note of 06/11/98 to the director of the Treasury's insurance division. They said that there were marketing as well as prudential aspects to the issue. PIA had not formed a view on the Equitable case. However experience of with-profit cases had shown that it was difficult to prove a complaint that would restrict a firm's flexibility in the way it declared bonuses. The author had not seen the wording of Equitable's policies which would clearly be significant. Nevertheless, while Equitable might properly be able to reduce bonuses, they were acting in poor faith in doing so.

GAD briefed the Treasury's insurance division to ask Equitable for any material supporting the adoption by Equitable's board of a two-tier terminal bonus system as a modification of policyholders' previous expectations.

13/11/98
The Treasury's insurance division, their legal advisers and GAD met Equitable to discuss GAR options and the implications for policyholders' reasonable expectations of Equitable's treatment of policyholders with such options. The Treasury's insurance division said that Equitable's policy of reducing terminal bonuses for policyholders with GAR options that were biting was a high profile industry issue. Equitable said that Counsel had endorsed their position and concluded that their directors had not used their powers improperly. They agreed to provide the Treasury with a copy of Counsel's opinion and supporting materials. The Treasury's insurance division said that projections to policyholders with GAR options had apparently shown the GAR applied to the unadjusted terminal bonus; Equitable said that even if that were the case, the level of terminal bonus had not been guaranteed. The Treasury's insurance division asked for information to allow them properly to understand what impression had been given to policyholders over the years. Equitable said that their sales force covered the GAR option in their dialogue with policyholders only if it was more attractive to the policyholder. The Treasury asked for a list of policy numbers that had matured in the last three years. They would then select a sample of maturing policies at random and examine them. They again told Equitable that they should reserve for what was payable under the contract, arguing **it was a statutory requirement and they expected Equitable to reserve on that basis** [their emphasis]. Equitable said that the timing of any additional reserving was a critical issue. There would be severe commercial implications from reporting low solvency cover, but they were convinced the company would remain solvent. Equitable said that they were considering applying for a section 68 order with respect to the resilience calculation which would assume only 50% of policyholders took the GAR option. They agreed that they would need to think about reducing bonus declarations, but said it was impractical to think that they could slash them harshly without serious implications for public relations. (FSA's conduct of business division were not represented at the meeting.)

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[According to the Baird report, Equitable's exposure to top-ups (whereby some policyholders were entitled to pay additional premiums at any time and any GARs applicable to the policy in question would attach equally to those additional payments, and which were referred to in Equitable's response to the GAD survey - see entry for 20/7/98) was also considered at this meeting, but I have seen no evidence of this.]

16/11/98
GAD told the Treasury's insurance division that, if differential terminal bonuses were permissible under the policy wording, then they seemed to be legally acceptable. Equitable might be open to policyholder complaints, but GAD did not believe that the Treasury could raise objections. Equitable had told GAD about the possibility of their applying this practice in their 1993 regulatory returns, but had first told policyholders in a bonus notice issued in January 1996. Equitable were reluctant to grant to GAR policyholders bonuses materially in excess of their asset shares, to the detriment of other policyholders. However there was still the question of whether their practice was consistent with policyholder expectations. GAD expected that early marketing literature would not have covered the possibility and Equitable were relying on their general discretion and accordingly remained open to legal challenge. GAD remained convinced that full reserves for guaranteed annuities should be carried.

The Treasury's insurance division wrote to Equitable asking for copies of literature given to policyholders and of Counsel's opinion. They also expressed concern that where the GAR option was biting to the extent that there would be no terminal bonus if the GAR option was exercised, the policyholder would receive lower benefits if choosing the cash option. The specimen contract provided prior to the 02/10/98 meeting could be interpreted as entitling the policyholder to cash to the same value as the GAR option in such cases. They repeated that Equitable were obliged to reserve on the basis that the GAR options would be exercised in 100% of cases, if more valuable than current annuity rates. The Treasury's insurance division said that they recognised that that could have a significant impact on Equitable's financial position. They asked for the latest estimates of free assets and solvency cover and for the latest management accounts. [The letter was copied to GAD but not to FSA's conduct of business division.]

18/11/98
Equitable sent a holding reply to the Treasury's insurance division, adding that surplus assets and implicit items before reserving for GAR options were around £2bn.

19/11/98
The then Economic Secretary, who was not content with the proposed guidance sent to her on 26/10/98, commented that if people had bought a contract it was a guarantee and they should not subsequently be expected to pay for the guarentee themselves. She questioned whether shareholders should bear some or all of the costs involved, also whether use could be made of free estate where it existed. [Neither point was in fact relevant in Equitable's case because they had no shareholders and no free estate to speak of due to their policy of full distribution to their policyholders.]

23/11/98
Equitable sent the Treasury's insurance division a full reply to their letter of 16/11/98 including: policyholder literature, illustrations of when the GAR option would and would not produce higher retirement income, and a copy of Counsel's opinion. Counsel gave the opinion that Equitable were "*justified in law*" in adopting the approach of declaring differential final bonuses in order to ensure (so far as was possible having regard to the operation of guaranteed annuities on previously guaranteed values) that the ultimate cash value of any given policy would be a single sum, irrespective of whether the policyholder took the guaranteed benefits under his policy or elected to take an alternative annuity based on application of the current annuity rate. Counsel added that the top-up element would be allocated by the Board exercising its discretion under article 65 (see 01/10/98), which was wide enough to enable bonuses to be allocated among members in top-up form as well as in annual and terminal form.

The Treasury's insurance division circulated Counsel's opinion to their legal advisers and to GAD for comment.

24/11/98
Equitable wrote to GAD, who copied the letter to the Treasury's insurance division and legal advisers. It was Equitable's view that since 1993 GAD had tacitly accepted their approach to reserving. [See also the entry for 04/01/99 below.] They could not see why, in the face of logic and practical experience, prudence necessitated assuming that 100% of benefits would be taken in the most onerous form. Equitable's auditors were said to support their position. Surplus assets at 30 October 1998 were £1,164m and they had a section 68 order allowing implicit items of up to £850m to be brought into account. Equitable argued against GAD's position, saying that the choices available, if onerous reserving were to be required, included declaring no bonus. If Equitable gave way to pressure to adopt an excessively prudent and over-cautious reserving basis, the consequences for the company were potentially extremely serious. Equitable said they would need to consider what steps to take in terms of consulting with the [actuarial] profession; informal soundings indicated they were not alone in their interpretation of Regulation 64.

Guidance note DAA10, from the Government Actuary, amended the guidelines for resilience test 2. The note said that, while the revised test was necessarily more complex, it was intended to avoid the unreasonable stringency which might apply if equity markets fell below their current levels. However, if applied to other types of business, it was not appropriate to include in the test any element which, taken overall, served to reduce the prudential effect of the test.

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GAD provided the Treasury's insurance division with a note intended to assist them in explaining their position more fully to the then Economic Secretary. They noted the difficulty for insurers such as Equitable, for whom the residual cost of the guarantee was relatively high, with no shareholders or free estate and where the guarantees fell to be met by either the beneficiaries or the remaining policyholders.

A manuscript note by the Treasury's insurance division said that it was important to be clear that there was no one right answer and that different solutions were possible, each of them fair.

25/11/98
GAD sent the Treasury's insurance division in confidence a report of the results of their survey which they had prepared in September. They pointed out, however, that the situation had moved on, as they were in the process of interviewing the worst affected companies and so the detailed information was now out of date. They said the quality of the survey responses had not been sufficiently rigorous for them to draw conclusions about the 74 individual companies and that the report should therefore be interpreted as giving only a general overview. The survey suggested that while most guarantee schemes were "*in the money*", some were not. Applying a minimum reserving standard of a prudent mortality rate, 4.5% interest and 2% for expenses, they believed that the industry would need to establish additional reserves of some £10bn, which did not include any allowance for costs arising from the receipt of future premiums under contracts with GAR options. Equitable seemed to be particularly vulnerable. Across all companies at the end of 1997 there may have been an unrecognised liability of some £3bn, around half of which related to Equitable, who could be technically insolvent [regulatory insolvency was intended]. The issue of annuity guarantees would be raised with each company as part of the scrutiny process for their regulatory returns. GAD stressed, however, that their methodology was open to question, as an annuity basis suitable to the whole population was likely to be unsuitable for a given product line. Most insurers writing with-profits business were considering carefully whether to reduce the final bonus to policyholders with GAR options; the practice was being followed by eight companies, including Equitable. Seven companies, including Equitable, did not inform policyholders about the existence of GAR options.

26/11/98
An updating note prepared by the Treasury's insurance division about the effect of current market conditions on life insurers noted that Equitable were one of four companies facing serious difficulties. Equitable were just covering the required minimum margin if all policyholders exercised their GAR options. Publication of such a low solvency position was likely severely to undermine their reputation and could threaten their survival as an independent entity. Discussions were continuing about the reserving basis to be used and Equitable's approach to charging policyholders for the cost of GAR options.

01/12/98
GAD reviewed the legal advice Equitable had sent on 23/11/98 and told the Treasury's insurance division that in their view the advice did not wholeheartedly support the actions Equitable had taken thus far. As they saw it the documentation to date had not adequately described the bonus methodology Equitable were adopting. Counsel had said, and GAD agreed, that the policy wording required Equitable to allocate the terminal bonus **before** the policyholder decided which benefit to take. However the legal advice to Equitable was that a differential terminal bonus could be applied under [article 65] requiring Equitable to declare a lower terminal bonus to GAR policyholders, with a bonus for those not taking the GAR option. It was possible that past policyholders whose policies had matured could successfully argue they had not been treated fairly. The Treasury's insurance division had also noted a risk that Equitable could be liable to pay the guarantee on top of the full fund, with a need for an appropriate provision. (An officer of FSA's prudential division commented in manuscript "*i.e. need to reserve on basis that Eq Life might **lose** in Court.*")

GAD wrote to the Treasury's insurance division about reserving saying that, under Regulation 64, policy valuation had to take account of all prospective liabilities, including guaranteed annuities. Equitable needed to have sufficient assets now to cover the final bonus that might be payable in lieu of the GAR option benefits. If Equitable reserved in full for 100% of benefits in GAR form, they would just have sufficient cover for their required margin of solvency as at 30/10/98. While this might not suit them commercially, it indicated that they were very reliant on future surpluses to fund future bonuses, including terminal bonuses. It was difficult to see how Equitable could justify declaring any bonus at the year-end. In the medium term they would need to look for some ongoing form of capital support if they were to remain viable under difficult investment and trading conditions.

02/12/98
The Treasury's legal advisers gave their insurance division interim advice on Counsel's opinion provided by Equitable on 23/11/98. They said that they found it hard to take issue with the opinion, although they noted that that had been given in the context of contract and trust law. They said that they understood the insurance division to be of the view that consideration of policyholders' reasonable expectations might go beyond that; were that to be the case, the opinion would not be an end to the matter. They said that the insurance division would want to reach their own view on policyholders' reasonable expectations. On the question of reserving, Regulation 64 was very wide and it was for the courts, not the Treasury, to decide if liabilities had been properly determined. There was room for more than one reasonable view of proper provision and prudent assumptions, though any entity adopting the Treasury's and GAD's view on reserving would be within Regulation 64. It was not clear, however, whether Equitable's view was in breach of Regulation 64; it would probably be for the Treasury to show a breach, not for Equitable to show compliance. If Equitable were not in

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breach, then the legal advisers were not clear on what basis the Treasury might take action against Equitable.

FSA's conduct of business division circulated a note to their managers on recent press articles about Equitable and other firms who had offered GAR options. They said that this might become a big issue affecting a large number of firms and costs of billions of pounds. There was speculation that mutuals might find it hard to survive if they had to honour GARs. FSA's conduct of business division commented on the difference in approach between prudential regulation, focusing on a firm's ability to stay in business, and conduct of business regulation, looking at what the firm had promised investors and whether they should be liable to pay the maximum figures. They said that they had been in touch with the Treasury's insurance division who were looking at the position, particularly with regard to Equitable's regulatory solvency, if the guarantees were enforceable. The insurance division were also reviewing Equitable's literature (policies and bonus notices) to enable them to take a view about what reasonable expectations a policyholder might have had from reading it.

03/12/98
The Treasury's insurance division and GAD met Equitable and told them that, in their view, there was at least a possibility that dissident policyholders seeking a GAR option on an unadjusted terminal bonus might win a case in court. Equitable admitted that that was at least a potential contingent liability. GAD denied Equitable's assertions that for several years they had tacitly accepted Equitable's approach. They said that they were aware from their regulatory returns that Equitable had written GAR option business, but not the construction of the contracts or the reserving basis. The Treasury said that they saw no scope for concessions on reserving. Equitable expressed concern that they were being forced to adopt a "*wildly prudent*" reserving approach, bearing no resemblance to commercial reality, and damaging to policyholders. On being told that there was no appeal other than by way of judicial review, Equitable said that they might well have to take up that option. They did not expect the policyholders' action group to bring legal action in the near future. Equitable said that they had considered reinsurance as an option to protect the balance sheet, but were reluctant to broadcast their position to potential reinsurers while they were still hoping the regulatory position might change. Even if reinsurance was purchased it was unlikely to be in place that year. The Treasury said they thought it would be possible to give a post-dated concession to cover the 1998 year end. However, they still had some way to go before coming to a conclusion about the reasonable expectations of Equitable's asset share treatment for policyholders with biting GAR options. The Treasury were concerned about whether policyholders' reasonable expectations had been met for policies that had already matured, and they gave Equitable details of the further material that they wished to see in relation to this.

04/12/98
The Treasury's legal advisers gave their insurance division further interim legal advice on the reserving issue. They said that, on balance, a court was likely to accept that Equitable's position was untenable, though they were not convinced that a court would accept that Regulation 64 required reserves to be made on the assumption of 100% take-up of GAR options. A court would be likely, however, to accept that 100% or thereabouts was required in this case if Equitable continued to maintain their position that a much lower rate could reasonably be assumed. Action to be taken if Equitable "*did not come quietly*" [which I presume meant if Equitable did not accept GAD's view on reserving levels for GARs] could include pursuing them for breach of section 45 (see paragraph 34) on the grounds that the criteria of sound and prudent management were not being met. Such intervention was unlikely to be successfully challenged in the courts. However, the onus rested on the Treasury to show that Equitable had breached the regulatory requirement. The legal advisers said that they still found it hard to take issue with Equitable's Counsel's advice in respect of the differential terminal bonus practice, although they reiterated their comments regarding the context in which that advice had been given [see 02/12/98].

07/12/98
The Treasury's insurance division sent Equitable a note of the main points of the 03/12/98 meeting. It said that Regulation 64 pointed to assuming that 100% of policyholders took their benefits in GAR form. To the extent that Regulation 64 could be disapplied by a section 68 order, the Treasury would not be inclined to make such an order. They rebutted the arguments on reserving advanced by Equitable and said that they did not accept that an assumed GAR option take-up rate of 35% was prudent, nor that a reserve based on the cash option should exclude a terminal bonus. Treasury's insurance division agreed to consider the possibility of any reinsurance arrangement as having been effective from the year end, provided that at least the broad terms of the agreement were in place by that date and a firm intention to enter into the agreement could be shown. They added that, if Counsel's advice was followed, there was little doubt that policyholders' reasonable expectations would be met in future, but they questioned whether they had been met in those cases where policies had already matured. They concluded that they expected to see in Equitable's regulatory returns an appropriate statement on contingent liabilities, related to the risk of successful challenge to Equitable's bonus practice for GARs.

08/12/98
GAD told the Treasury's insurance division that an alternative valuation basis for GAR contracts could satisfy Regulation 64. It could be reasonable to assume that less than 100% of policyholders would elect to take the GAR, provided that the reserve held in respect of those assumed to take an alternative form of benefit was based on a realistic value of that alternative. They suggested a formula for calculating this and said that while it might be prudent in Equitable's case to assume that only 50% of

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policyholders were to choose the GAR option, the value of the alternative option should be not less than 95% of the liability arising if the guaranteed benefit were selected. GAD said that they had no objection to Equitable being permitted to phase in the new formula over a reasonably short period of time, subject to their providing assurance that the phasing in would be completed before significant liabilities began to arise. They also recommended that the Treasury's insurance division seek some commitment from Equitable to reduce the declared reversionary bonus until full provision for the GAR liabilities had been made. GAD added that Equitable's reply to the survey of 29/07/98 had disclosed their significant exposure to GAR options. GAD offered to discuss Equitable's approach with the appointed actuary.

In an internal note (not copied to the prudential division) FSA's conduct of business division commented that the relevant annuities had all been sold before the Financial Services Act 1986 came into force and so were probably not caught by PIA rules. However, if Equitable should have provided for paying the GAR and full terminal bonus but had not, and had therefore been able to offer investors returns in recent years more generous than they would otherwise have been able to, then that now enabled them effectively to inflate past performance figures. FSA's conduct of business division decided, before taking any action, to await the outcome of the Treasury's insurance division's review of how Equitable were interpreting their obligations against the test of policyholders' reasonable expectations. Any action would need to be taken working closely with the Treasury's insurance division.

09/12/98

The Treasury's insurance division gave the then Economic Secretary more background to the proposed further guidance letter on policyholders' reasonable expectations, including a fuller justification for the lower final bonus, and again sought approval. They said that the particular difficulty for Equitable was that guarantees had either to be met by the benefiting policyholders, or spread across all with-profit policyholders who shared in the overall profits and losses of the relevant business. As Equitable had approximately 25% of its with-profits business affected by GARs, and the level of guarantee was high, the impact on the total amount of bonuses payable was relatively large. Equitable were charging the residual costs of the GAR options to the beneficiaries by reduced final bonus. Contractually it was arguable whether they were obliged to spread the cost more evenly across all policyholders and the Treasury were seeking more information about that. There would be no failure of policyholders' reasonable expectations where an insurer had an asset share policy that had been clearly communicated.

10/12/98

Equitable told the Treasury's insurance division that they did not accept the Treasury's view of what constituted a prudent reserve; in the light of favourable legal advice they had received, they were willing to challenge any use of FSA powers through judicial review. Equitable said that they were also pursuing the possibility of reinsurance and wished to meet with the Treasury's insurance division again shortly.

The head of the prudential division said, in a personal file note, that Equitable must reserve on the basis of the contract and must cover all guaranteed annuities. The consequences for Equitable were serious but needed to be faced **now**. Referring to policyholders' reasonable expectations, he said that it was at least arguable that they should pay guaranteed annuities on the 'full' final sum as the literature implied this. There was a risk of needing to reserve for higher payments for 1994-98, and a need to make an appropriate reference to contingent liability in the regulatory returns. At 25% above current rates, Equitable [GAR] policyholders would find cash commutation attractive across a wider range of economic conditions than other companies.

11/12/98

The Treasury's legal advisers told their insurance division that there was no provision to require a company to reissue or amend accounts when it had breached Regulation 64. They expressed the belief that a court would expect the Treasury's insurance division to prosecute a clear breach of the Insurance Companies (Accounts and Statements) Regulations 1996 [which prescribe the form and content of the annual returns that companies are required to submit] or to act under section 45 of the Insurance Companies Act (paragraph 34) if they considered Regulation 64 insufficient in a particular case. They said that a decision to intervene to direct that past published accounts should be corrected would have to be supported by good grounds.

c15/12/98

In preparation for handing over prudential regulation to FSA, the Treasury's insurance division briefed FSA's chairman and the managing director on their current views on Equitable's position. Equitable proposed to reserve for 25% of GAR options which meant free assets of £2,452m; the Treasury said that, if Equitable reserved for 100% of GAR options, their free assets would then only be £220m and insufficient to declare a bonus, the cost of which, assuming they maintained the current level, would be £500m. The Treasury's view was that they must reserve at or close to 100% for GAR options. This was because Equitable were effectively having to guarantee to pay terminal bonuses to GAR option policyholders at a level which made the cash option worth as much as the GAR option; accordingly they should reserve for what was effectively a guaranteed benefit. The Treasury said that they were not minded to act for failure to reserve fully for GAR options in the 1997 returns (which would be consistent with the approach taken with other companies) but Equitable would be formally told that FSA would intervene if the 1998 returns did not comply. Intervention, which would be likely to be in terms of closing the company to new business, would follow if Equitable either declared a further bonus without prior discussion with the Treasury, or declared a bonus that would breach its required minimum margin if GAR options were fully

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reserved. They concluded that Equitable could be expected to seek judicial review of any intervention action in relation to reserving for GAR options.

15/12/98
The Treasury's insurance division and FSA's chairman and relevant managing director met for a briefing on issues relating to Equitable, including the draft guidance on the reserving standards required. FSA queried the nature of the future profits that could be taken into account to cover a company's solvency margin. The Treasury explained that only future profits on business already written, and only a conservative estimate of that, was allowed in the returns. As to the fact that no action had been taken against Equitable in respect of their 1997 returns, FSA's managing director said that he considered it defensible for the Treasury to change their view as the picture filled out and the significance of GARs changed. It was considered that Equitable's Counsel's opinion provided reasonable comfort that their approach of reducing terminal bonuses to meet the cost of the GAR was consistent with policyholders' reasonable expectations. The Treasury went on to say that, assuming 100% reserving for GAR options was necessary, Equitable should not be permitted to make itself insolvent [in a regulatory sense] by declaring further bonuses - but they also acknowledged that not to declare a bonus would be very damaging commercially; the chairman was reported to have said that for Equitable to be forced to pass a bonus would amount to commercial suicide. The Treasury added that they had had discussions with several other companies which had accepted that GAR options had to be fully reserved.

FSA's chairman was concerned that the Treasury's approach should be defensible in view of the risk of judicial review; the proposed guidance letter (on reserving policy) would be helpful. FSA's managing director expressed concern that any relaxation in the Treasury's position on reserving levels for GAR options would undermine their position, as any level below 100% was necessarily arbitrary. He was also concerned that the Treasury did not appear to have solid support for their position from GAD. The Treasury said that GAD were considering a relaxation of the reserving requirement to 97.5%. It was suggested that Equitable, or another company acting in response to guidance that the Treasury proposed to issue on the required level of reserving, might seek judicial review of their position. It was felt however that, even if that were to happen, it would not block any action that the Treasury might wish to take against Equitable in the meantime. A move by the Treasury to prevent Equitable declaring a bonus could be justified as action to prevent a breach of the criteria of sound and prudent management, and so should be outside the immediate scope of any judicial review. FSA's chairman said that Equitable might prefer seeking a buyer to judicial review. It was agreed that a takeover would not be a good result for the company or for the Treasury. The chairman considered it important to understand the sensitivity of the financial positions of Equitable and others to movements in gilt yields; the Treasury said that they would assess this further. It was noted that Equitable had reported little contact with the policyholders' action group and had received few complaints. The Treasury told FSA that, importantly, the financial position would not be made worse (assuming it had already reserved at 100%) if Equitable had to abandon the approach of reducing the terminal bonus paid to policyholders exercising the GAR option. The only additional cost would be topping up payouts that had already been made to policyholders. FSA agreed that the Treasury appeared to be taking the only sensible approach.

GAD told the Treasury's legal advisers and the Treasury's insurance division that they did not agree there were no grounds to require a company to amend or reissue accounts that breached Regulation 64 and pointed to sections in the 1982 Act which they believed did give the Treasury that power.

Following the fuller justification of 09/12/98, the then Economic Secretary agreed the draft guidance letter to insurers first proposed by GAD on 09/10/98.

16/12/98
In reply to a complaint from a policyholder about Equitable's differential terminal bonus policy, the Treasury's insurance division said that guaranteed benefits did not normally extend to discretionary final bonuses. A number of insurers therefore considered that the level of discretionary bonus might be adjusted to ensure fairness between policyholders. Such an adjustment was particularly relevant for mutual insurers, who would find it difficult to provide additional amounts of discretionary bonus beyond the value of the accumulated premiums attributable to the policyholders in question, without prejudicing the interests of other policyholders. The Treasury believed that they were treating all mutual insurers in a similar manner.

Equitable's Board resolved to initiate a test case in the courts to determine whether they had the right to declare differential terminal bonuses.

17/12/98
The Treasury's insurance division sent the draft guidance (on the principles which life insurers should follow in determining how to handle GAR options in the context of policyholders' reasonable expectations) to FSA's managing director. They said that, while the letter set out general principles, which were intended to ensure a consistent and fair approach overall, some commentators were likely to see it as relating primarily to Equitable.

Equitable sent the Treasury's insurance division some of the documentation requested at the meeting on 03/12/98.

18/12/98
The Treasury's insurance division issued to life companies their guidance letter (DD1998/5) on policyholders' reasonable expectations. They said that policyholders with GAR options could expect to pay some premium towards the cost of those options. They considered that, generally,

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it would be appropriate for the level of charge to reflect the perceived value of the guarantee over the duration of the contract. That could be achieved in some cases by a reduction in the terminal bonus added at maturity, though the approach to be taken by each company would depend on the wording of the contract involved and how it had been presented to policyholders. They said that each company would have to assess the appropriateness of such adjustments to bonus allocations in the context of the reasonable expectations of all policyholders; that assessment would be influenced by the policy documents and any representation made through marketing literature, bonus statements or elsewhere. The guidance was given without prejudice to any decision of the courts.

Equitable sent the Treasury's insurance division joint leading Counsels' opinion, which said that the Treasury's requirement for reserving was manifestly unfair and open to judicial review as in breach of Equitable's legitimate expectations, and also ran contrary to policyholders' reasonable expectations as it would lead to a reduction in future bonus payments. Equitable said that they had decided, on leading Counsel's advice, to initiate a test case in the High Court to confirm that their directors had acted properly and within their powers on their practice on terminal bonuses. (A Treasury officer's manuscript marginal notes commented that they had not been aware that GARs had exceeded current annuity rates to any significant extent from 1994 onwards, and that they had acted as soon as they had become aware of the situation.)

GAD told the Treasury's insurance division that at the meeting on 28/05/98 they had urged Equitable to exercise great restraint in granting guaranteed bonuses. GAD did not accept that it would necessarily be commercial suicide for Equitable to grant no additional guaranteed bonuses that year on contracts containing GAR options, so long as the reasons were properly explained. Indeed, this was probably necessary for prudent management.

The Treasury service level agreement with FSA was signed. The Treasury contracted out to FSA responsibility for most aspects of prudential regulation (certain matters, such as the issue of section 68 orders could not be contracted out and were reserved to the Treasury).

late 12/98
The Treasury's insurance division received the remainder of the materials requested from Equitable on 03/12/98.

22/12/98
The Treasury's insurance division and GAD met Equitable to discuss the legal opinion of 18/12/98. The Treasury agreed to provide a formal response to the legal opinion as soon as possible. They commented that it was for Equitable to reserve as they saw fit, but that the Treasury would take regulatory action if reserves were inappropriate or if Equitable's actions imperilled solvency margin cover. They would act, for example, if bonus declarations were imprudent. Equitable agreed to liaise with the Treasury prior to deciding a bonus strategy, but did not guarantee not to pay further bonuses to policyholders with GAR options. They said that, although they were looking to reduce bonuses generally, it would be difficult not to give policyholders with GARs some bonus. Equitable repeated that they did not agree that the reserve should be 100% and that the regulatory regime did not require reserving for terminal bonuses, this was something the Treasury were suddenly applying.

The Treasury said that the terminal bonus was effectively guaranteed up to the value of the guaranteed annuity since if no terminal bonus was added, everyone would take the guaranteed annuity. For their part, GAD again [see 03/12/98] denied that they had tacitly accepted Equitable's past reserving practice for GAR options. They pointed out that the information disclosed in the return was limited and gave them no reason to question the validity of the reserving basis. They said that the actuarial working party had concluded that holding no reserve and assuming the cost of GAR options could be met from terminal bonus was imprudent. The Treasury said that 100% reserving was being required industry wide.

Equitable said that they accepted the need to put up a substantial reserve but still considered the level the Treasury required to be excessive. They said that reserving for the full amount of the guarantees would seriously constrain investment strategy, and low solvency would threaten the company's future. These combined could put immense pressure on them to find a buyer. They added that there were further margins in the reserving that could be released, giving them further free assets of approximately £200m; they could also apply for a section 68 order for a larger future profits implicit item up to £1.9bn. The Treasury acknowledged that they were likely to treat such an application sympathetically.

Equitable suggested that the blow could be softened by assuming that 30% of all relevant policyholders would take the guaranteed annuity, while reserving at 100% in respect of those policyholders closest to retirement. The Treasury said that they were sympathetic to that aim, as they understood the potential for policyholders to be adversely affected by a "*sudden hit*" of such magnitude and they agreed to consider any such proposal as an interim measure. Equitable concluded that they were actively discussing reinsuring the reserves for GARs.

Equitable applied for a revised [see 26/06/98] section 68 order for a future profits implicit item of £1.9bn, to be counted towards their solvency margin on 31 December 1998.

23/12/98
GAD told the Treasury's insurance division that they supported the application for a section 68 order.

31/12/98
The Treasury's legal advisers reaffirmed to GAD their view that there was no power as such to require reissue or amendment of accounts which breached Regulation 64. They also gave their insurance division a draft response to the legal opinion provided by Equitable on 18/12/98.

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Equitable asked the Treasury's insurance division for a response to the legal opinion as promised at the 22/12/98 meeting. Equitable said that they had received an offer in respect of a financial reassurance arrangement from a reinsurer. Further information would be provided shortly after 07/01/99 "*should we wish to proceed*". Attachments sent with the letter included a copy of a fax dated 23/12/98 from the reinsurer saying that they were most interested in finalising a contract that would meet the needs of Equitable in respect of the issues discussed; it was hoped to resolve these to enable a contract to be drawn up to reflect the concept discussed. A manuscript endorsement by the Equitable recipient said: "*… this, apparently is the letter of intent, and we shall not be receiving anything else in writing before our meeting on 7 January*". The costs would be: an annual premium of £50,000; in the event of a claim, 2% of the claim; repayment of any claim over about three years from earnings in excess of those required for the statutory valuation.

The Treasury granted Equitable's request for the section 68 order.

Equitable had over £28bn of investment funds under management, which included over £21bn in their with-profits business. The statutory reserves required for GARs were £1.6bn.

1999

01/01/99
The Treasury's insurance division transferred to FSA and operated subsequently as part of the Insurance and Friendly Societies Division [to whom I shall refer as FSA's prudential division]. Their legal advisers transferred to FSA's General Counsel's Division.

04/01/99
GAD told FSA's prudential division that they were reviewing Equitable's mathematical reserves and that three actions were required: first, to tell Equitable they were not satisfied with zero mathematical reserves (paragraph 28) for the GARs in the 1997 returns; secondly, to provide Equitable with a response to Counsel's opinion; and thirdly, to obtain additional information from Equitable about mathematical reserves, resilience, and asset shares, and also the most recent financial condition report produced in accordance with the Faculty and Institute of Actuaries' guidance note. GAD also commented that Counsel had overlooked the key point that prudent assumptions about the proportions of policyholders who might exercise each option ought to depend on the relative values of the benefits, which had increased considerably in the recent past as interest rates fell. Recent take-up rates were irrelevant as additional discretionary cash sums had been paid to those choosing the cash option rather than the GAR, but Equitable did not propose to make provision for future additional cash bonuses. GAD accepted, with hindsight, that they might have questioned rather earlier Equitable's treatment of GARs in the context of the 1993-1996 regulatory returns; however, Equitable had not sought to discuss the question of reserving with GAD or with the Treasury's insurance division, even when it had become a material issue. GAD said that they had not accepted the reserving basis used in the 1997 regulatory returns, and had not had any direct communication with Equitable about them. They agreed that if Equitable were to establish a £1.5bn reserve, it would affect future bonuses, and said that they would consider the question of phasing in the higher reserving requirement in the light of the additional information now being sought.

FSA's legal division told their prudential division that Counsel's opinion provided by Equitable did not cause them to change their view set out in their letter of 07/12/98, and did not even seek to address the regulator's position on the issues. Policyholders could be expected to select the cash commutation only while its value was maintained at close to the value of an annuity taken at the GAR rate. GARs should, therefore, as a matter of prudence be fully reserved. The GAR problem had been revealed only when the Treasury had begun to consider the responses to the GAD survey.

07/01/99
FSA's prudential division briefed their chairman recommending further draft general industry guidance on reserving for GARs and that FSA's prudential division should require companies whose 1997 regulatory returns did not comply with the new guidance to submit their 1998 returns early. They proposed writing separately to Equitable and attached a draft letter. They said that Equitable had a legitimate expectation that they had until the end of June to present their 1998 return (subject to them not declaring a bonus that would threaten their regulatory solvency). Requiring an accelerated return from them would mean a real risk of a successful judicial review. Action involving a wider group of companies enhanced the possibility of a collective industry challenge. There might be difficult questions about those companies whose 1997 returns were not prepared in accordance with the guidance now being issued and whether FSA would act against them. FSA's prudential division were clear that action to prosecute the companies for supplying improper returns would be a disproportionate response and in any event very unlikely to succeed. [The briefing was copied to the managing director but not to the conduct of business division.]

11/01/99
FSA, following advice from their legal division and GAD, told Equitable that Counsel's opinion had not changed their view of 07/12/98 that GARs must, as a matter of prudence, be fully reserved to within a few percentage points, even though changed economic circumstances had increased significantly the quantum of reserves required. The reality that the discretionary bonuses must continue to be adjusted, if policyholders were to continue to opt for the cash fund, substantially fettered Equitable's discretion not to pay additional bonuses. FSA said that they did not accept that DTI or the Treasury had had notice, as Equitable's Counsel asserted, that the GARs referred to in Equitable's regulatory returns made since 1993 were higher than the current annuity rates. If Equitable

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considered that the reserving requirement should not be enforced and intervention action not taken, clear and convincing arguments would be needed. Any arrangement falling short of the normal reserving requirement would need to be disclosed in the statutory return.

13/01/99
The Government Actuary issued guidance to all appointed actuaries (reference DAA11) reminding them to make proper provision for all GAR liabilities on prudent assumptions. Reserving requirements would be very similar whether a GAR was the principal benefit or only an option. It was necessary to reserve fully for all alternative benefits offered under the contract. It would not be prudent to assume that policyholders would choose a benefit form of significantly lower nominal value, although an allowance of a few percentage points could be made for other perceived advantages of alternative benefits. Where the terminal bonus was adjusted to bring the value of the GAR option closer to that of the alternative benefits, any reduction in reserves by more than a few percentage points below the full value of the GAR option would need very careful justification by the actuary. The need to hold mathematical reserves to cover GARs should not reduce the stringency of the resilience test to be applied. FSA and GAD would review closely the level of reserves established for GAR options in companies' 1998 regulatory returns.

FSA's prudential division wrote to the managing directors of life insurance companies saying that they had recently asked GAD to circulate to all appointed actuaries guidance on reserving for GARs. Managing directors were asked to review their financial position with their appointed actuary and tell FSA the outcome by 15 February. FSA pointed out that the 1997 regulatory returns for some companies did not conform with the new guidance. Those companies should submit their 1998 returns early, not later than 31/03/99.

The Treasury briefed the then Economic Secretary to note the circular and press notice that FSA were about to issue and to note the scope for criticism from with-profits policyholders who would mostly bear the reserving costs of GARs combined with the liabilities for the costs of pensions mis-selling. FSA's concerns were to ensure that solvency was maintained and that policyholders' reasonable expectations were met. Additionally, the appointed actuaries must have sufficient independence and freedom to discharge their professional responsibilities, including advising the directors on protecting the interests and reasonable expectations of policyholders. In the first instance, FSA should answer any press or policyholder criticisms; the Treasury would only become involved if the adequacy of the regulatory framework or the performance of the regulator were to be called into question.

14/01/99
FSA issued a press notice saying that they had given all life insurance companies guidance on reserving for GARs and asked them to consider, depending on the information given in their 1997 returns, bringing forward publication of their 1998 returns.

15/01/99
Equitable sought a court declaration that article 65 gave them discretion to allot different amounts of terminal bonus to GAR policyholders when the applicable GARs were higher than the current annuity rates, so as to equalise the total value of benefits taken by any given policyholder.

The PIA Ombudsman began to tell complainants that he had concluded that Equitable had identified an important point of law and, in the circumstances, he should presently cease to consider and investigate complaints relating to Equitable guaranteed annuities by reason of the proceedings to be instituted in the High Court. He would keep the progress of the litigation under review.

18/01/99
An internal FSA minute from the head of advertising supervision to the head of conduct of business said that he was concerned that FSA had issued guidance (the prudential division's guidance to insurance companies on GARs of 13/01/99) representing the position of one part of FSA, when other parts of FSA had not had the opportunity to consider the matter properly. He said that that was particularly relevant when, as on this occasion, the conduct of business division's position might differ from that of the prudential division. Given the size of the GAR problem, the conduct of business division felt obliged to look closely and check whether any of the activity of the life insurers fell within their jurisdiction. They might decide that insurers had not done anything since 1988 which would fall under PIA's selling and marketing jurisdiction; on the other hand they might find something which they would feel obliged to pursue as part of their general brief to protect investors. Their instinct was to find out how the guarantees had been promoted to investors and, if appropriate, to require firms to honour their promises. The approach of FSA's prudential division was to preserve the financial soundness of companies by agreeing that bonus rates to GAR policyholders could be reduced, creating a clear conflict between conduct of business regulation and prudential supervision. The press notice reference to protecting policyholders had been a bit unfortunate. The author of the note said that he would hate to have to explain to a policyholder how they were protecting him or her by agreeing that the insurer could pay a pension substantially less than expected. He presumed that there was some mechanism within FSA to co-ordinate regulatory activity and asked if they should be noting their interest at a higher level.

Prompted by GAD, FSA's prudential division asked Equitable for further information about their reserves, assets and financial condition.

20/01/99
In an internal note, FSA's prudential division said that Equitable had said that they would reply to them on bonuses and financial reinsurance within a day or two.

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Equitable expected the court case to be taken in late September, but an appeal could push it into the next year.

The conduct of business division circulated a note considering what their involvement should be in relation to guaranteed annuities. They noted that policies sold before 29/04/88 were probably outside jurisdiction. However, given the media attention, it seemed sensible to consider in more detail the issues raised by Equitable's treatment of GAR options to see if there was action that they should be taking to fulfil their regulatory obligations. Apart from any new sales after that date, top-ups of existing contracts or switching policyholders out of policies with GAR options might have generated documents providing information to policyholders about regulated products. Concern remained about the potential for conflict between the obligations of FSA's conduct of business and prudential divisions. The prudential division had interpreted the requirement for a company to meet policyholders' reasonable expectations to mean that GAR policyholders could reasonably expect to pay something for the benefit of the GAR. The conduct of business approach was to find out how guarantees had been promoted and, if appropriate, to require firms to honour their promises. There might thus be a clear conflict between the obligations of conduct of business regulation and prudential supervision.

21/01/99
Equitable replied to the prudential division's letter of 18/01/99 promising the data in a few days. They said that they planned to declare a 5% bonus for 1998, down from 6.5% for 1997. Equitable continued: "*as you are aware, we have entered into a financial reassurance arrangement with effect from 31 December 1998, as you helpfully suggested in your letter of 7 December 1998*" [Treasury's insurance division had then agreed to accept reinsurance] with the aim of enabling Equitable to reserve at a level they felt prudently reflected their likely future experience. The appointed actuary would take up the matter direct with GAD to confirm that this would have the intended reserving effect. The reinsurance was a financing arrangement which would provide support to Equitable when more than 25% by value of the GAR business maturing in that year selected the GAR option. The cost was to be £150,000 per annum.

FSA's prudential division briefed the FSA Board on issues facing the insurance regulator, including the spiralling cost to the industry of meeting annuity guarantees. The Board noted that the Treasury remained responsible for prudential regulation until the Financial Services and Markets Act was implemented in full [01/12/01] (paragraph 6) and that any major change in policy would need to be agreed with them.

22/01/99
Equitable's appointed actuary told their Board that the lowest assumption as to the proportions of benefits taken as GARs that would not contravene GAD guidance was between 65% and 80%. Fewer than 1% of relevant clients had exercised GARs in 1998. In the absence of regulatory pressure, a suitably prudent assumption would be for 25% of benefits to be taken as GARs. He added that that was also the level of reserving the reinsurance arrangements being negotiated were intended to facilitate. He recommended a declared bonus for 1998 to be based on a return of 5%.

FSA's prudential division said in a briefing that Equitable was one of four companies giving cause for concern, principally due to GAR options. It was questionable whether Equitable would be able to declare a bonus. Equitable had agreed to discuss with FSA in advance any proposed bonus declaration. Based on GAD guidance, Equitable appeared to be just solvent with £1.15bn available assets covering a regulatory solvency margin of just under £1bn. They had sought and received an increased future profits implicit item of £1.9bn and were exploring the possibility of reinsurance for their GAR liabilities. Not to declare or to limit the annual bonus and to publish a low solvency position in April would be commercially damaging; their survival as an independent entity could be threatened. Should the court case go against Equitable their financial position could become even more precarious, and they might become liable to enhance past settled claims.

25/01/99
PIA published revised rules and explanatory guidance on the rates of investment return and mortality assumptions to be used for projections of future benefits under life and pensions policies.

26/01/99
Equitable provided the additional financial information that FSA's prudential division had sought on 18/01/99.

FSA's prudential division asked Equitable for copies of papers relating to any bonus recommendations made to the Board within the previous 12 months and to the valuation by the appointed actuary at the end of 1997.

FSA's legal division told the prudential division, in the context of a draft reply to a Member's request for a copy of FSA's guidance, that any FSA decision on policyholders' reasonable expectations might be viewed by the courts as unfair if policyholders were not formally invited to make submissions to FSA on the matter. They also said that it would be helpful to see the papers relating to Equitable's court case. (FSA's prudential division did not request those papers from Equitable until June 1999.)

FSA's prudential division told their legal division of their strong preference not to reach a decision on policyholders' reasonable expectations until after the court case.
The court decision would not preclude FSA from taking a view on intervention, but the judgment of whether or not policyholders' reasonable expectations had been met would depend crucially on the precise nature of the individual contracts, so that it would be sensible to await the court's decision on the legal position.

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27/01/99
GAD commented to FSA's prudential division (copied to the legal division) on the financial reinsurance arrangement which Equitable were proposing. They said that they had no details about the financial strength of the reinsurer or what support, if any, the reinsurer's parent company might guarantee them. They said that the reinsurance treaty provided support to Equitable in any year when more than 25% (by value) of the guaranteed business vesting in that year chose the GAR option. It limited the reinsurer's overall exposure at any time to £100m. If claims were raised, Equitable would create a debt in their balance sheet and repay a recovery amount each year until the debt was fully repaid. The cost to Equitable was £150,000 per annum. Either party could cancel the treaty retroactively to the previous 31 December if certain contractual events occurred. The treaty could also be cancelled if Equitable changed their practice on GAR options which, GAD presumed, would include Equitable losing their court case.

At a meeting of the Tripartite Standing Committee (paragraph 37) FSA reported the dispute with Equitable about their reserving policy and the proposed bonus payments. They said that there were a number of options for handling this, including the possibility of reinsuring some liabilities, or limiting the bonus paid. It was agreed that FSA would continue discussions and report back to the next meeting.

28/01/99
GAD and FSA's prudential division met with Equitable to discuss the draft reinsurance agreement. According to FSA's note of the meeting, there were a number of issues of concern in relation to the drafting of the treaty, though it was considered that the treaty was capable of being revised so as to address each one. First, was the way in which the liability to the reinsurer was defined. Secondly, Equitable were unclear as to why it had been proposed that it should be possible for the reinsurer to cancel the treaty retroactively, and agreed that that would not be appropriate. Equitable agreed also to look to reduce the circumstances under which the treaty could be cancelled. Thirdly, there was a concern that reaching the £100m limit would trigger cancellation. Equitable said that that was not the intention, it was intended only to provide a right to review the terms of the treaty. If no agreement could be reached on revising the terms, the treaty would continue unamended. Equitable would look at redrafting the provision so that that was clearer. GAD emphasised that repayment of outstanding reinsurance claims should be subordinated to policyholder claims. Equitable asked how the reinsurance might be presented in the annual returns; they preferred not to show a reserve of more than £1bn for GAR options as they believed that that would be seen as indicating the real cost of those options to the company. FSA emphasised that their main concern was that the reserving basis should be clear from the returns. GAD had not yet determined the implications of the reinsurance treaty for the level of the future profits implicit item for which Equitable could take credit in their returns. Equitable said that they expected to use only the £850m originally applied for. They said that they expected to agree the revisions to the treaty during the following week and would supply GAD/FSA with the updated version. Following GAD's query of 27/01/99, the question was also raised as to whether Equitable were satisfied that the reinsurer was financially strong enough to fulfil the potential obligations under the treaty (to cover a potential £1bn+ liability). In response Equitable highlighted the reinsurer's AAA rating which GAD subsequently confirmed.

29/01/99
GAD told FSA's prudential division that they had been provided with copies of relevant Board papers relating to Equitable's proposed bonus declaration. They said that the papers showed that Equitable were sensibly seeking to balance a progressive reduction in the additional guaranteed benefits each year with a reasonably competitive position and smoothing bonus declarations in line with the perceived expectations of policyholders. The cost of the declared bonus for 1998 would be some £365m; assuming that the reinsurance was completed, and that it was accepted by FSA as allowing a significant reduction in the reserves, Equitable would, based on their draft 1998 returns, cover their solvency margin by 250%, a similar level to that shown for 1997. Without the reinsurance, cover would be only 110%, though Equitable would then be able to take credit for a larger future profits implicit item. The financial position shown was likely, therefore, to appear reasonably satisfactory, though they would be potentially close to regulatory action for failure to maintain the required minimum margin if the reinsurance were not completed satisfactorily. It would be difficult to object formally to what Equitable were proposing though their position would need to be monitored carefully. They went on to say that the current reserving standard was not unreasonably harsh, with the possible exception of the resilience reserve requirement on GAR policies, which would be dealt with by the proposed reinsurance. When telling Equitable that they would not object to the proposed rate of bonus, GAD and FSA's prudential division should voice their concerns about Equitable's vulnerability and ask them to produce some contingency plans on how they would react to adverse investment conditions. GAD also noted that Equitable continued to issue annual notices to policyholders showing a high level of projected benefits and thereby generating further expectations.

GAD telephoned Equitable to discuss the valuation basis underlying a valuation result in an Equitable Board paper. GAD told Equitable that further discussion would be needed before FSA's prudential division would be able to accept that certain adjustments that Equitable were proposing to make to their valuations basis would produce acceptably prudent reserves. The discussion revealed that Equitable had included an allowance of £450m for future top-ups in their reserve calculation.

In a note of that call, GAD commented that Equitable now seemed to be accepting the ultimate need for full provisions, but appeared to be hoping to phase them in,

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and had suggested that the Treasury had given that idea a favourable mention at an earlier meeting. No further progress had been made on the draft reinsurance treaty, but Equitable saw no major problems arising and hoped to reach final agreement the next week.

01/02/99
FSA's prudential division wrote to Equitable, saying that it was important that they resolve the points of concern around the reinsurance treaty since, in the absence of a robust reinsurance agreement, it would not be prudent to declare any bonus for 1998. Without reinsurance, solvency margin cover would appear so low as to be easily eliminated by a small move in market conditions. If allowance was made for the proposed reinsurance treaty Equitable's financial position appeared significantly stronger, although even then Equitable would need to consider carefully the scope for declaring a bonus, given the uncertainties surrounding the financial implications of losing the court case. They should also take into account their heavy dependence on the reinsurance for solvency cover, and the risk of its being cancelled by the reinsurer by reason of losing the court case or for some other reason. FSA said that those were matters of judgement for Equitable in the first instance but, on the basis of the information provided, and assuming that the treaty were revised to resolve GAD's concerns, they were not minded to object to the proposed bonus declaration. They asked to be kept informed of progress on revising the terms of the reinsurance before reaching a final view on the proposed bonus declaration. FSA concluded that Equitable should not take FSA's decision not to intervene over the bonus declaration as an endorsement of what Equitable were proposing and added that they remained concerned about Equitable's ongoing financial health. They asked for revenue and solvency projections and contingency plans.

03/02/99
Equitable told FSA's prudential division that discussions with the reinsurers were proceeding and that they hoped soon to be able to provide a revised version of the treaty. They said that they had already considered their position in the unlikely event of losing the court case, and that they would be discussing that with their Board.

12/02/99
Equitable sent FSA's prudential division a copy of the draft reinsurance terms, saying that amendments had been negotiated to reflect the points made by FSA at the meeting on 28/01/99. They said that there now seemed to be no impediment to their proceeding with the planned bonus declaration.

Equitable sent a further letter in reply to FSA's letter DAA11 of 13/01/99 to all life assurance companies about reserving for GARs. Equitable said that their 1997 regulatory returns did not comply with the new guidance and that to achieve that, they would have had to use the full £700m future profits implicit item rather than the £371m that they had used in the submitted returns, to achieve the same result. The solvency margin would then have declined from 2.5 times to 2.0 times, but this would still have been consistent with the ratios that had given them an AA financial strength rating for the last five years. The reinsurance coupled with the full use of the £850m future profits implicit item would restore the margin to the level in the returns as submitted. In light of that, Equitable said, they saw no necessity for their 1998 returns to be submitted earlier than normal.

The managing director told the FSA Board that further consideration had been given to the position of those life companies affected by GARs and pensions mis-selling. FSA's prudential division were giving particular attention to the case of Equitable, who normally declared their annual bonus in February.

16/02/99
FSA's prudential division told Equitable they still had one concern with the revised draft reinsurance agreement relating to the provision for settlement of claims. They wanted to see that issue resolved before Equitable declared a bonus, and they offered a further meeting later that week.

18/02/99
GAD told the prudential division that the revisions which Equitable had now faxed to them had not addressed all the points in their letter of 16/02/99.

The prudential division replied confirming that a meeting had been arranged with Equitable the next day to discuss and agree in principle the proposed reinsurance treaty. They said that they hoped that "*we only ask for further changes [to the reinsurance terms] if absolutely necessary, especially as we have already made requests that go further than what we had indicated we wanted in earlier discussions*".

GAD agreed that they should keep to a minimum any request for further changes to the terms, but added that they should be very careful about giving firm agreement to the full effect of the treaty without seeing the final wording.

19/02/99
In his weekly report to the managing director, the director said that Equitable's bonus declaration was still subject to satisfactory reinsurance arrangements being put in place. If FSA were satisfied that the reinsurance was effective, Equitable were likely to approve a 5% bonus on pensions business - a drop of 1.5%, and at the low end of industry declarations, but better than had at one stage seemed possible.

22/02/99
FSA's prudential division told Equitable that their position remained unchanged: subject to the reinsurance treaty having the effect of allowing an appropriate offset to be made, FSA's prudential division were not minded to object to Equitable's proposed bonus declaration. However, they would still expect the points they had made to Equitable in

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their letter of 01/02/99 to be taken into consideration when deciding the scope for declaring a bonus.

GAD wrote to Equitable setting out the points covered in their discussion of 19/02/99. GAD confirmed that they accepted the principle of the reinsurance treaty allowing an offset if 25% of policyholders took benefits in GAR form, but said that they still needed to see the final version of it.

23/02/99
The court ordered that a named policyholder (Mr Hyman) should represent the interests of all policyholders in the matter of GARs, but said that that did not preclude a policyholder from seeking relief based on allegations about the way policies had been sold, if those allegations were based on facts not before the court.

24/02/99
FSA's prudential division told Equitable that their 1997 regulatory returns might have given potential policyholders a misleading impression about Equitable's financial position. They recognised that Equitable had taken action to address the situation but said that that had not strengthened the company's financial position to a point where it was as strong as had been presented in the 1997 returns. Equitable would have to rely on a much larger future profits implicit item in the 1998 returns, even with the reinsurance agreement, to achieve the same apparent solvency margin cover. Equitable were asked to agree by 3 March to submit the 1998 returns by 31 March 1999 or face possible regulatory action.

FSA reported to the Tripartite Standing Committee that they were still discussing Equitable's plans for reinsurance of some of the risks. If those plans were approved, then Equitable would pay a 5% bonus, which was at the lower end of market expectations.

26/02/99
The FSA director told the managing director in a weekly report that Equitable had now arranged satisfactory reinsurance which had cleared the way for them to announce a 5% bonus on most policies. They had also been invited to accelerate submission of their regulatory returns to the end of March.

Equitable agreed to submit early the 1998 regulatory returns.

03/99
Equitable rejected an approach made by another mutual life company for the companies to merge and then demutualise.

The FIA issued a position statement on annuity guarantees to enable its Officers, Council members and senior members of staff to respond to questions from the actuarial profession, members of the public and press. [The statement, which was placed on the profession's web site, was not formal guidance and said that it should not necessarily be taken as a full expression of the profession's views on the subject.] The statement said that the precise position of insurers in relation to their annuity guarantees would vary substantially depending on the exact wording of policy terms and conditions, references made in marketing literature and other representations made by the insurer on the subject. Companies needed to consider their individual position, and also to consider the reserves required in order to meet their policyholders' reasonable expectations. The Treasury's letter of 18 December 1998 demonstrated that there was considerable variation in how policyholders' reasonable expectations might be interpreted but individual offices might be constrained in different ways. The profession fully supported the regulator's position as set out in that letter. The Appointed Actuary of each insurer had a duty to ensure that sufficient reserves were held to meet that insurer's obligations under its own approach.

02/03/99
FSA's prudential division told their chairman that Equitable had volunteered to submit their 1998 returns early, but did not wish this to be divulged ahead of publication. Responses to the January guidance indicated that companies were now reserving for guaranteed annuities to a common minimum standard, which was an important safeguard for policyholders.

03/03/99
A firm of solicitors then acting for Equitable (Equitable's then solicitors) asked FSA's prudential division to confirm that the Treasury would consent to a proposed supplement to the subordinated loan agreement and to any consequent modifications to the section 68 order of 19/08/97.

05/03/99
FSA's prudential division asked GAD for advice on Equitable's request of 03/03/99.

10/03/99
The first quarterly meeting between the Treasury and FSA's prudential division took place. FSA explained that there might be a problem with the way in which some companies were reserving for GARs; they said that they would need to monitor those companies and request early returns. No specific reference to Equitable was recorded.

18/03/99
The managing director told the FSA Board that FSA had been reviewing companies' exposure to GARs. He said that after setting aside reserves consistent with [FSA's] guidance, Equitable's free assets were so low that the prudence of paying a bonus that year had been questionable. Equitable had now put in place a reinsurance treaty to cover the additional reserving liability and would declare a reduced bonus of 5% (which he said was at the lower end of the industry range for 1999). They had also agreed to submit their regulatory returns early.

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19/03/99
In an internal memo FSA's prudential division summarised the position of the six companies identified as being potentially at risk from GAR options and whose statutory solvency could be threatened if economic conditions were to deteriorate. Of those six, Equitable was viewed as giving rise to the greatest concern. A second group of five companies was said to be of less concern because, although each had substantial exposure to GAR options, all had, or were acquiring, well capitalised parent companies. They said that Equitable's financial position had been very severely affected. A reserve of £2.9bn would be required at the end of 1998. After establishing that level of reserving, and allowing for significantly reduced levels of bonus, they would only just be able to cover their regulatory solvency margin. Equitable were seeking to finalise a reinsurance agreement which would reduce the reserving requirement by some £2bn, thereby increasing the solvency margin to a more acceptable level. However, they remained concerned about the viability of Equitable in the longer term. Equitable had declared high levels of guaranteed bonus in the past and their ability to honour those guaranteed bonuses appeared to be heavily dependent on their continuing to achieve high investment returns. Their liabilities for GAR options could also increase significantly if gilt yields fell further. Equitable had agreed to provide financial projections for their business over the following three years, which would enable the prudential division to make a more accurate assessment of the longer-term position. However, if Equitable were to lose the court case they could also incur significant compensation costs.

24/03/99
Responding to a proposal by FSA's prudential division to seek information from two insurance companies about proposed changes to their terminal bonus practices, GAD said that they saw a serious danger in picking on a few companies, perhaps with worse financial positions than average, and pressuring them to adopt a more generous line, while less threatened companies continued to operate the same practices without question. They suggested a new survey of practices covering all companies with any GAR exposure, since much had changed since their 1998 survey.

The prudential division replied to GAD that their proposal had arisen from concerns that their approach to the two companies in question was not consistent with their approach towards Equitable (and one other). They had asked Equitable (and that other company) to say how their approach was compatible with policyholders' reasonable expectations, and believed that they should do the same for any other company whose bonus practice gave rise to similar concerns (which they believed to be the case here). They went on to say that, due to resource implications, their practice had been to seek information about differential bonus practices and their compatibility with policyholders' reasonable expectations only where it had been brought to their attention that such a practice was being adopted. They had not wanted to "*go looking for trouble*", but had thought that they needed to be seen to do something where the issue had been raised. They accepted, however, that there was a case for a more systematic approach. They concluded that they did not have the resources to look at large numbers of documents from different companies to determine whether they met policyholders' reasonable expectations. However, they might cope with a more limited exercise whereby they asked companies to explain how their approach was consistent with policyholders' reasonable expectations, and then assessed the reasonableness of their replies. They asked whether GAD were suggesting that they should undertake such an exercise.

GAD replied that they believed that most companies were awaiting the outcome of Equitable's court case, and that a further survey would probably be needed after the case had been resolved.

30/03/99
Equitable submitted their 1998 regulatory returns, which disclosed the reinsurance agreement (but did not say that it was contingent upon there being no change to Equitable's differential terminal bonus policy). In the returns Equitable assumed between 70% and 82.5% of eligible policyholders would take the GAR option.

GAD told FSA's prudential division that there was no good reason for the Treasury to object to the request of 03/03/99 from Equitable's solicitors for a proposed supplement to the subordinated loan agreement. They said that the revised position was adequately covered by the existing section 68 order [and therefore there was no need to put the matter to the Treasury].

FSA immediately passed that information on to Equitable's solicitors.

Equitable applied to FSA's prudential division for a section 68 order to allow a future profits implicit item of £1bn to be used towards their required solvency margin on 31/12/99; they said that the sum applied for took account of the reinsurance arrangements. They added that they had included a future profits implicit item of £850m in their 1998 returns.

FSA's prudential division asked Equitable, in the light of falling interest rates, to provide by 30/04/99 an update on their latest estimate of the costs of the expected liabilities arising from the personal pensions review. They also reminded Equitable of their continuing responsibility to tell them immediately if Equitable's regulatory solvency margin was likely to be breached or if policyholders' reasonable expectations could not be met.

31/03/99
The prudential division initially recorded Equitable's 1998 regulatory returns as priority rating 3. [FSA have since explained that this was the rating given in the prior year. Following initial and detailed scrutiny, GAD assigned Equitable's regulatory returns a priority rating 2 in May 1999 - which meant that they would be subject to a priority 2 ranking scrutiny in the following year.]

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01/04/99
Equitable sent the reinsurer a letter of understanding, not intended to be legally binding, to clarify the intentions of the parties to the reinsurance treaty "*incepting 31 December 1998*". The letter said that if the withheld fund exceeded £100m, and no solution could be found under the Agreement terms, then the treaty would be cancelled. Equitable would not request a cash payment from the reinsurer for any item unless it was essential to satisfy regulatory requirements. The intention of the treaty was to create flexibility for Equitable in their reserving. [Equitable faxed this letter to FSA on **24/09/01**; FSA told my investigators that neither they nor the new management of Equitable had previously been aware of the letter. FSA issued a press release to that effect on 26/11/01 and launched an investigation into why they had not received a side copy of the letter in April 1999.]

09/04/99
GAD reported to FSA's prudential division the results of their initial scrutiny of Equitable's 1998 regulatory returns, saying that the financial position appeared satisfactory. Equitable were covering their solvency margin by a factor of 2.5, which would be reduced to 1.66 without the future profits implicit item. They had made allowance for non take-up of GARs to a greater extent than GAD had considered appropriate in the light of the Government Actuary's guidance. However, the solvency implications were negligible, as the reinsurance treaty should largely cancel out any increase in the provision that would be required by raising the assumed take-up rate. GAD said that they could only presume that Equitable had been reluctant to disclose any higher figures for their gross liability, or the extent of their consequent reliance on the reinsurance. GAD added that they had not yet seen a copy of the finalised reinsurance treaty and they asked FSA's prudential division to request it urgently. They said that they aimed to complete a combined detailed scrutiny of the 1997 and 1998 returns by the end of June. [This was consistent with priority rating 2.]

15/04/99
FSA's prudential division asked Equitable for a copy of the completed reinsurance agreement. They repeated their request of 01/02/99 for revenue and solvency projections and contingency plans.

20/04/99
Equitable told FSA's prudential division that they were still waiting for the finalised treaty from the reinsurer but enclosed a copy of the terms sheet, on which they said the treaty would be based. They said that that was as discussed with GAD in February, except for one point which had been amended in line with GAD's advice. The solvency projections requested on 01/02/99 were not yet available due to the additional work that had been occasioned by the early submission of the regulatory return. They expected to make those projections available to the prudential division by the end of the month. (The terms sheet showed that the reinsurance was contingent on no change being made to Equitable's then current GAR practice, either by choice or as a result of legal action; and that if the withheld claims balance exceeded £100m, the treaty would be "*restructured*". No mention was made of cancellation).

Equitable also enclosed a copy of a paper, prepared for their Board by their appointed actuary, on the measures open to the company to protect their statutory solvency position. One issue that the paper discussed was how Equitable might use policy conditions to restrict growth in GAR business and prevent policyholders from making top-up payments to existing policies. It said that if in any policy year no premium was paid, the terms on which future premiums would be accepted would be at Equitable's discretion. That meant that in any year when no premium was paid, they could, in theory, withhold in respect of future premiums any guarantee applying under the policy. The disadvantages to such an approach, however, were that: having traded on the flexibility of their products, Equitable could then be seen as penalising customers who sought to take advantage of it; they would need to give policyholders warning of their intentions, and of the rights that they stood to lose; and policyholders might then make minimal payments to maintain their rights to the guarantees, which would negate much of the benefit that Equitable might hope to gain. The paper concluded with a list of measures which it was said it would seem sensible to pursue. These included: taking on further subordinated debt; using reinsurance (to capitalise future profits through a financial reinsurance agreement); shifting the equity portfolio to higher yielding stocks; actively encouraging policyholders to give up their GARs; and gradually introducing new products with no entitlement to declared bonuses.

21/04/99
FSA's prudential division copied Equitable's letter, with enclosures, to GAD. They asked GAD whether it was appropriate for Equitable to take credit for the reinsurance treaty in their 1998 regulatory returns if the treaty had not yet been finalised.

27/04/99
GAD commented to FSA's prudential division on the measures which Equitable had put forward in the Board paper [see 20/04/99 entry]. They said that the measures looked "*fairly plausible*", but could ultimately reduce investment returns (which they said the paper clearly recognised), and one of the options discussed ("*threatening*" lower annual rates of return to GAR holders - with the option of giving up the GAR in exchange for higher bonuses) might conflict with product and marketing literature. They said that FSA had already agreed in principle to reinsurance and had told Equitable that where there was a letter of intent in place at the valuation date, credit could be taken for the existence of a reinsurance agreement. Commenting on the changes that had been made to the treaty, they said that they were content with the level to which adjustment premiums (that is Equitable's obligation to repay in the future any sums paid out under the treaty) were subordinated to policyholders' rights. They noted that the premium payable by Equitable had increased from £150,000 to £400,000.

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29/04/99
Equitable sent their 1998 Companies Act [statutory] report and accounts to FSA's prudential division.

In an internal memo FSA's conduct of business division noted that they had visited the PIA Ombudsman to discuss complaints received about guaranteed annuities, particularly concerning Equitable; the division had also been liaising with FSA's prudential division on the issue. They understood that most of the complaints in question had been about policies sold before 1988, so there was little action that they could take. They noted that there was a possible conflict between the respective positions the FSA was required to take in respect of prudential supervision and conduct of business regulation. They concluded that, in view of the court case, there was little to be done at that time from a supervision angle.

30/04/99
Equitable wrote to the then Economic Secretary protesting that FSA's approach to reserving for guaranteed annuities bore little resemblance to commercial reality and was likely to lead to lower benefits for policyholders. Equitable said that the regulatory guidance on reserving for policies containing GAR options was extremely onerous. While they had estimated the cost of meeting the guarantees at £50m, and with the agreement of their auditors had included a prudent provision of £200m in their accounts, thereby allowing for a significant deterioration in future financial conditions, to comply with the terms of the guidance they would have to set up an additional reserve of £1.6bn. They said that the modest cost of the reinsurance, and the acceptance by their auditors of their provision of £200m, were evidence of the excessively prudent nature of the reserving requirements. Equitable complained about the likely effect on the industry of the reserving requirement, believing that FSA and GAD had limited room for manoeuvre, and said that Ministerial intervention might secure a more commercial and satisfactory outcome.

04/05/99
Equitable sent FSA's prudential division the projected solvency information requested on 01/02/99; FSA's prudential division passed it to GAD for comment.
The projections were made on the basis of three different scenarios, each making different assumptions as to the state of the investment market. The projections showed Equitable remaining solvent under each of the three scenarios. Equitable said that the projections assumed declared bonus rates at $\frac{1}{2}$% lower than for 1998, and that in the least favourable of the three scenarios, bonus levels could be lower still. Long term projections to 2003 showed the solvency position improving steadily under each of the three scenarios. Equitable said that assuming investment conditions similar to those prevailing at 31/12/98, they estimated the commercial cost arising from GARs at £50m, though experience showed the actual cost to be lower. Estimating that cost in respect of the scenarios used for their solvency projections, they said that under the least favourable scenario the cost would rise to £500m, while at the other extreme it would disappear altogether.

Equitable had also attempted to project the impact of losing the court case, but that was difficult to do as there were a number of components, any one of which could have an impact on solvency. Taking what they described as a less favourable (but not the worst possible) outcome, they said that, if that were coupled with the least favourable of the scenarios used for the solvency projections, the position would become unacceptably tight. (A manuscript note by FSA's prudential division commented "*why wasn't this scenario demonstrated?*") In summary, Equitable said, they remained statutorily solvent in a number of scenarios; the long term projections showed an improving regulatory solvency position; and the shorter term position was capable of being strengthened. The key solvency consideration of an unfavourable outcome from the court case was replacement or modification of the reassurance arrangement, which they said was being actively pursued.

05/05/99
Following policyholder complaints, FSA's prudential division agreed with the conduct of business division to be responsible for handling queries relating to GARs and the acceptability of insurers cutting terminal bonuses to policyholders exercising a GAR option. This was on the grounds that this was largely an issue of policyholders' reasonable expectations.

11/05/99
The second quarterly meeting between the Treasury and FSA's prudential division took place. According to the minutes, GARs were not discussed, although the Treasury did ask FSA's prudential division to provide a contribution to a reply to a policyholder's letter of complaint about Equitable.

18/05/99
The Treasury asked FSA's prudential division for advice on Equitable's letter of 30/04/99 to the then Economic Secretary. They said that the Economic Secretary had found odd, and if true disturbing, the requirement for Equitable to set up an additional reserve of £1.6bn.

20/05/99
GAD gave FSA's prudential division a detailed scrutiny report on Equitable's 1997 and 1998 regulatory returns; the priority rating given to Equitable was 2. [FSA told my staff that detailed scrutiny of the 1997 returns had been held over to be completed alongside detailed scrutiny of the 1998 returns, which Equitable had been required to submit early - by 31/03/99. This meant that the detailed scrutiny of the 1998 returns was available much earlier than it would normally have been.] GAD said that as a result of current market conditions GARs were proving extremely onerous, although Equitable were attempting to restrict the ultimate value to policyholders exercising those options to their appropriate accumulated asset share. In reserving for those liabilities, Equitable had made assumptions as to the number of policyholders who would opt to exercise the guarantees which stretched the concessions offered in the 13/01/99 guidance letter (DAA11); a policy decision was therefore needed as to

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whether to challenge Equitable's reserving assumptions for the guaranteed annuities. FSA and GAD also needed to consider the final terms of the reinsurance agreement. GAD said that losing the court case would result in Equitable having to reduce the terminal bonus additions for a wider group of policyholders, possibly all of them. Section 68 orders for future profits implicit items had risen from £700m (£371m used) on 14/10/97 to £1,900m (£850m used) at 30/12/98. The total current asset shares, which had been indicated to members as their policy values, exceeded total current admissible assets.

GAD went on to say that a large proportion of Equitable's business was written on a participating basis, so that, provided the currently high level of annual emerging surplus continued, Equitable should be able to work their way out of their solvency margin problems. They considered it highly desirable, however, in view of the risks posed by the possibility of a downturn in asset values, that Equitable should hold back more emerging surplus by declaring lower guaranteed bonuses, though they could still pay out appropriate final benefits by way of non-guaranteed bonuses. It would seem desirable that policyholders should be given some greater warning about the possible implications for future bonuses of a substantial market setback.

21/05/99
In an internal note, which appears to refer to Equitable's solvency projections of 04/05/99, GAD suggested further plausible scenarios which Equitable should be asked to consider. They added that Equitable should also be asked to confirm that they had allowed for the cost of the bonus as at 31/12/99, and that the estimated reserves at that date had been calculated on a basis comparable with that used for the previous year.

FSA's prudential division provided the Treasury with a briefing note addressing the concerns that the then Economic Secretary had expressed following Equitable's approach to her. They said that they did not consider the size of the reserve that they were requiring Equitable to set up for GAR options to be disproportionate to the risk the company was carrying. An attached note explained that the reserving standards applied in Treasury returns were invariably more onerous than general accounting standards, requiring a level of reserve sufficient to meet all reasonably foreseeable circumstances. In Equitable's case the difference between the two (£1.4bn) was larger than normal because Equitable were effectively making an assumption in their accounts that equity prices would continue to rise. While that may be acceptable in company accounts, it was not considered prudent for statutory reserving. Further, the approach taken by GAD towards reserving for GAR options had been widely endorsed within the actuarial profession.

24/05/99
FSA's prudential division passed on extracts of the GAD scrutiny (20/05/99) to their head of division saying that they would have to challenge the GAR reserving assumptions as making allowance for cash commutation was contrary to specific guidance from the Government Actuary and a reserving level of 70% seemed unacceptably low.

25/05/99
FSA's conduct of business division received a letter from the Consumers' Association (dated 21/05/99) expressing their concern at the failure of some pension providers to honour guarantees and at the potential for insolvencies. The conduct of business division passed the letter to the prudential division, who decided to meet the Consumers' Association.

The prudential division told GAD that they had discussed the issue of Equitable's apparent low gross reserve and had decided to take a "*low profile*" approach to obtaining clarification of the basis for Equitable's reserving for GAR options. It had therefore been agreed that they would ask GAD to obtain this from Equitable, presenting it simply as a normal request for clarification of actuarial assumptions. They asked GAD for sight of a copy of their draft letter to Equitable.

27/05/99
GAD accordingly asked Equitable to explain how in their reserving calculation they had arrived at the proportion of policyholders taking benefits in GAR form, and how the reinsurance offset had been calculated. Referring to the solvency projections that Equitable had submitted on 04/05/99, they said that they were surprised at the low level of reserves required at the end of 1999 relative to the projected cashflow, and they asked for confirmation that no further material change had been assumed in valuation bases. They also asked for a projection of Equitable's position at the end of 1999 on the basis of a further scenario where gilt yields stayed at around 5%, while equity values fell by 10% over the year.

28/05/99
The conduct of business division contacted the prudential division about the concerns that the Consumers' Association had raised over insurance companies refusing to honour guarantees, and that companies might be concealing information from policyholders. The conduct of business division's view was that the first point was a matter for the prudential division, while the second was for them and would probably be addressed in the course of their routine supervision visits.

01/06/99
FSA's prudential division told the conduct of business division that they understood the Consumers' Association's main concern to be that policyholders were not being told when their policies matured that those policies contained GAR options, and they might therefore end up buying a lower value market annuity.

02/06/99
After further discussion of the issues raised by the Consumers' Association, the conduct of business division said that the position was unclear; there were issues

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about whether policies had been sold before or after the Financial Services Act 1986 came into effect; whether advice had been provided at the time of sale and by whom (a representative of the insurer or an independent adviser); and where a company's responsibilities lay. They had sought legal advice on the matter and were awaiting a reply.

c02/06/99
An undated file note, apparently prepared by FSA's prudential division as briefing for a meeting with the Consumers' Association that had been arranged for 14/06/99, said that any reduction in terminal bonus was acceptable only to the extent that it was consistent with policyholders' reasonable expectations and that the acceptability of cutting the terminal bonus would depend on what policyholders had been told when they had taken out the contract and subsequently. The courts would clarify some issues, and FSA were awaiting their judgment before considering particular cases. However, in general, FSA saw GAR options as an additional benefit for which some charge could reasonably be made if costs were incurred in providing benefits. Most insurers based payouts for with-profits policies on asset shares, where the benefits equalled the premiums paid (less expenses) plus a proportionate share of the investment return achieved; reducing terminal bonus selectively to policyholders exercising a GAR option was consistent with that approach. The conduct of business division monitoring teams were looking at documentation issued to policyholders. A number of companies had taken steps to control their liabilities, through reinsurance or other hedging techniques. Companies had to reach a commercial judgment as to whether it was worth paying for protection of liabilities that might increase, decrease, or disappear altogether.

02/06/99
The conduct of business division noted that they regarded GAR options as broadly a prudential issue to be dealt with by the prudential division; the conduct of business division would await the outcome of the court case and the PIA Ombudsman's view on existing complaints.

c02/06/99
The then Economic Secretary queried why the reserving standards applied in the Treasury's regulatory returns (as set out in the relevant regulations) should be "*almost always more onerous than those in general accounting standards*".

04/06/99
FSA's prudential division provided GAD with a copy of their proposed advice to the then Economic Secretary on GAR option reserving. In draft paragraphs for the Economic Secretary, the prudential division said that companies had to take into **account all reasonably foreseeable circumstances** [prudential division emphasis] in setting their statutory reserves. Companies were not required to assume the absolute 'worst case' scenario but had to reserve to take account of potential adverse economic circumstances. They had to err on the side of underestimating the value of future income and overestimating liabilities. The determination of how conservative assumptions should be was derived from past experience and embodied in guidance to appointed actuaries.

On or about this date, GAD told the prudential division, in a note commenting on the issues raised by the then Economic Secretary, that insurance legislation required insurers to reserve for "*all guaranteed benefits*" on the basis of "*prudent*" assumptions; it also specifically provided that insurers must reserve for any additional costs of policy options. Equitable had set up a gross additional provision of £1.6bn at the end of 1998 for GAR liabilities. This was the provision for the additional liabilities they would face in applying the annuity rates guaranteed to policyholders to the cash benefits arising under the GAR pension contracts. The guaranteed cash benefits under these contracts were currently some £4.5bn, the total combined provision of £6.1bn was, in fact, close to the "*fair share*" of the accumulated fund that related to the GAR contracts. The cost of the GAR options and hence the reserving requirement had become significant due to recent falls in long term interest rates. Where Equitable had guaranteed rates in the region of £110 per annum per £1000 cash available, the best current market rate for an equivalent annuity was now only of the order of £80 per annum per £1000 of cash pension fund. GAD added that the reserving standards applied in regulatory returns were almost invariably more onerous than general accounting standards. In their statutory accounts Equitable were effectively assuming that equity prices would continue to rise so that the resulting capital gains produced surpluses of sufficient size by the time the GAR contracts matured to enable Equitable to discharge their liabilities to policyholders. While this might be acceptable in [statutory] company accounts, it would not be considered prudent in the regulatory accounts as it made no allowance for the risk that equity prices might fall and the assumed surpluses not arise. GAD said that their guidance on reserving standards had been widely endorsed within the actuarial profession and that a significant number of actuaries considered that a stronger reserving basis should have been required.

09/06/99
GAD commented on an unattributed, undated paper (which FSA say was prepared by the prudential division and circulated on 08/06/99) setting out various possible outcomes of the court case; their comments were copied to the legal division. The prudential division's paper identified four possible scenarios and set out the implications, as the prudential division saw them, for both FSA and Equitable in each case. The four scenarios were that (i) Equitable won; (ii) Equitable won in part (namely that it was then acceptable to reduce the terminal bonus, but had not been so in the past); (iii) Equitable won (in total or in part) on contractual grounds, but FSA would have to take a view on the outcome's acceptability from the perspective of policyholders' reasonable expectations; and (iv) Equitable lost (meaning that reducing the terminal

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bonus where a GAR option was exercised was unacceptable). Under the third scenario the prudential division noted that they would expect to conclude that Equitable's practice was then acceptable, but it was more doubtful that it had been so in the past, when, they said, bonus notices had been of dubious clarity. They added that they needed to try to define some more detailed criteria for determining when a terminal bonus reduction was, and was not, consistent with policyholders' reasonable expectations. GAD, in comments on the prudential division's paper, pointed out that, unless Equitable's practices were given full clearance by the courts, modification or replacement of the reassurance arrangement was essential. The prudential division's paper said that under the fourth scenario Equitable would need to look at reducing substantially the terminal bonus payable to all policyholders (or those with a GAR option irrespective of whether it was exercised?) and the prudential division would need to assess the consistency of Equitable's actions with policyholders' reasonable expectations. The reinsurance cover could be invalidated and leave Equitable only just able to cover the required minimum margin of solvency. FSA would need to determine Equitable's regulatory solvency and might need to consider closing the company to new business or suspending their authorisation if their liabilities to policyholders or policyholders' reasonable expectations might not be met. There could be an increase in the lapse rate of policies, a need for a change in Equitable's investment policy, compensation for the GAR holders whose policies had already matured and the effect that all of those things might have on Equitable's financial position. If the impact led to a takeover bid the prudential division continued, FSA would have no authority to protect Equitable from it; policyholders' interests should be protected but the industry would lose a well respected company. There could be a fall in the level of new business. FSA would need to address concerns that policyholders were losing out and the prudential division saw potential for allegations that FSA should have prevented Equitable from writing new business earlier.

The prudential division provided the Treasury with comments on a draft reply to Equitable's letter of 30/04/99 to the then Economic Secretary.

11/06/99
By FSA's account, their prudential division contacted Equitable by telephone on this date and requested copies of relevant material in relation to the Court case.

14/06/99
The then Economic Secretary replied to Equitable's letter of 30/04/99 explaining the purpose of the requirements of the regulatory returns. She said it would not be appropriate for her to comment on, or intervene in, a particular case where there was dialogue between a company and the regulator. She said that companies had to take account of **all reasonably foreseeable circumstances** [her emphasis] in setting their statutory reserves. If the guaranteed benefits under the annuity option were higher than those available in cash form, then it must be prudent to reserve for the higher value benefit.

FSA's prudential and conduct of business divisions, with GAD, met the Consumers' Association. A note of the meeting, prepared by the prudential division, said that there appeared to be much more common ground between FSA and the Consumers' Association than FSA had expected. FSA had been able to alleviate the Association's concerns that insurers were not honouring their guarantees and the Association had acknowledged the difficulty of being fair to all policyholders in meeting the costs of GAR options and the appropriateness of the costs being met from the with-profits fund.

The prudential division told their legal division and GAD that they had asked Equitable for the court papers, which Equitable had agreed, subject to legal advice, to provide. The court hearing was due to start on 05/07/99 and had been scheduled to last for two or three days. Equitable had said that there was a possibility of significant delay before the judgment was published.

15/06/99
FSA's legal division told the conduct of business division (who copied the advice to the prudential division on or around 14/07/99) that advice about GAR options given to, or withheld from, policyholders by companies after 29/04/88 - when the Financial Services Act came into effect - would be subject to the conduct of business rules, even if the policy had been sold before that date. Failure by a company to tell policyholders on maturity about their rights to GARs would undoubtedly breach PIA principles.

FSA's prudential division agreed to meet PIA Ombudsman staff on 23/06/99 to discuss complaints which the PIA Ombudsman had received about the cutting of terminal bonuses on policies with guaranteed annuities. They said that they would like also to discuss a number of other issues, including the PIA Ombudsman's jurisdiction on complaints concerning pre and post 1988 policies; the factors taken into account in an adjudication; how the PIA Ombudsman would reach a view on policyholders' reasonable expectations and the scope for them and the prudential division reaching a common view on that; and their handling of complaints. They said that they considered it important to understand the PIA Ombudsman's thinking in that area, as they would need to take a more general line on policyholders' reasonable expectations after the court judgment. They also wanted to understand the potential financial implications for insurers of the PIA Ombudsman's rulings.

16/06/99
The prudential division received a pack of materials relating to the court case from Equitable's then solicitors (as requested 11/06/99).

17/06/99
FSA's prudential and conduct of business divisions held a general bilateral meeting. They noted that the court case, and its implications for policyholders' reasonable expectations, would be a key milestone for guaranteed annuities. The prudential division said that they were waiting for the end of June regulatory returns from companies to review the basis of reserving for GARs.

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In an internal e-mail the conduct of business division said that they had agreed with the prudential division at that day's bilateral meeting that FSA would pilot lead supervision (paragraph 36) with 11 firms, including Equitable. The e-mail was addressed to two of the conduct of business division's staff who would be directly involved in the pilot, and said that the scheme would involve meetings with their counterparts from the prudential division to discuss, among other matters, supervisory plans. The results of the pilot would be reported in October 1999. The e-mail asked that the recipients tell their prudential division counterparts of any visits planned for the following quarter to any of the firms concerned.

18/06/99
Equitable's solicitors sent FSA's prudential division a copy of the subordinated loan capital agreement and asked them to confirm that the Treasury would not require any alteration to the section 68 order consenting to the modifications made to the loan agreement dated 04/08/97. [See entry for 30/03/99.]

21/06/99
Equitable wrote to FSA's prudential division saying that their lawyers had advised them not to prepare a fully documented contingency plan on the grounds that it might be unhelpful were it to become discoverable in some future legal action. Equitable said they had, however, given considerable thought to the ramifications of the various possible outcomes of the case and had identified six possible scenarios. The scenarios were described in an attached note as: (i) complete success [for Equitable]; (ii) success but with some adverse comment; (iii) directors had discretion [to determine different levels of bonus to policyholders choosing the guaranteed annuity rate], but had incorrectly executed it on technical grounds; (iv) directors had discretion, but had not given sufficient weight to, or considered, policyholders' reasonable expectations; (v) Equitable's approach was invalid and final bonus rates on cash and annuity benefits had to be equal but the Board still had discretion to set rates at a level they deemed appropriate; (vi) Equitable's approach was invalid and that final bonus rates on cash and annuity benefits had to be equal, but due to policyholders' reasonable expectations had to be set at the cash levels. Equitable set out briefly the implications as they saw them for each of the scenarios identified. For scenario (vi) these were that an appeal was certain but the judgment would stand until the appeal was heard. A Special Board meeting would be held by Equitable to consider cutting the ongoing growth rates on policies with GARs. Any Board resolution would be backdated. Both retirements and surrenders were likely to be large; past retirements would almost certainly require further payment. They said that they were discussing with the reinsurer possible amendments to the reinsurance treaty to cope with the fifth and sixth scenarios and had been in discussion with other reinsurers regarding other types of arrangement. Their lawyers, however, considered all but the first and second scenarios to be highly unlikely.

c22/06/99
The prudential division prepared a paper following their review of Equitable's court documents. They said that Equitable's arguments revolved around their 'asset share' approach, and made no mention of policyholders' reasonable expectations. Equitable had indicated that, even were they to lose the case, they would look to spread the cost of GAR options across those policyholders holding such an option, irrespective of whether or not they exercised it [i.e. ring-fencing]. Mr Hyman had been selected as he was the only complainant to the PIA Ombudsman whose policy had matured. Although the PIA Ombudsman had relinquished his jurisdiction on a number of complaints to the court, it was not clear whether he was still free to come to a different view on the basis of factors beyond the scope of the court, such as policyholders' reasonable expectations.

22/06/99
GAD briefed FSA's prudential division on the papers relating to Equitable's court case. They said that the papers appeared to demonstrate that Equitable had been cognisant of the GAR issue in 1993 and had taken action at the earliest moment that it had become relevant. There was an argument before the court that the Board's discretion to decide bonus levels could not be unfettered and absolute and must take into account other principles, particularly policyholders' reasonable expectations. It was also being argued that documents that Equitable had provided to policyholders had implied that bonuses would not be reduced where an annuity was taken at the guaranteed rate. GAD said that it was unlikely that the court would be able to ignore any consideration of policyholders' reasonable expectations; while the court could in theory decide that that was a matter for FSA, that seemed unlikely.

FSA's enforcement team began to investigate direct sales of pension fund withdrawals by Equitable who dominated this market.

At the FSA's Chairman's Committee, the director acknowledged that the relationship between the prudential division and the area of authorisations, enforcement and consumer relations could be further improved.

23/06/99
FSA's prudential division, accompanied by GAD, met the PIA Ombudsman. A note of the meeting said that Equitable had accepted the PIA Ombudsman's pre-1988 Act jurisdiction. The differential terminal bonus practice was at the core of policyholders' complaints and was an Equitable Board policy. Matters concerning Board policy and whether directors could act in a particular way were outside the PIA Ombudsman's remit. The PIA Ombudsman would look at policyholders' reasonable expectations only in terms of misrepresentation. If there were an appeal in the court case, the PIA Ombudsman would not communicate further with policyholders until after that had been decided.

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24/06/99
The prudential division asked the conduct of business division if they had reached a view as to whether information provided to holders of policies taken out before 1988 fell within their jurisdiction. They also asked whether the conduct of business division had any jurisdiction in relation to bonus notices issued to policyholders, and whether they could require Equitable to change those notices. The prudential division said that they had been unhappy for some time with the format of Equitable's bonus notices, as the way the terminal bonus was indicated was potentially misleading, and it was arguable that the format of the notice would encourage policyholders to believe that their guarantees would apply to the full fund, including the terminal bonus. The conduct of business division told the prudential division that they had concluded that they should look at the current bonus notice.

According to the Baird report, around this time the prudential division sent copies of Equitable's bonus notices for 1996 and 1997 to the conduct of business division for their views. They said that they would obtain copies of Equitable's 1998 notice the following week, commenting that the 1998 notice was expected to be more clearly drafted. [They did not send them Counsel's opinion advising Equitable to change the format of their bonus notices from 1998 onwards.]

GAD told the prudential and legal divisions that one of the more awkward scenarios that FSA should consider at that stage would be if the court found for Equitable in terms of contract law, but referred the issue of policyholders' reasonable expectations to FSA. Should that happen, FSA could apply a similar test to that used by the courts in judicial review, namely simply look at whether Equitable had acted in bad faith or had overlooked some salient fact. That would avoid the need to interfere in what might otherwise be seen as a commercial decision, which properly fell to the directors of the company. GAD said that in their view Equitable's asset share approach to distributing benefits was tenable, and that any question as to whether a policyholder had been misled at the point of sale would be for the PIA Ombudsman. As to Equitable's illustrations and bonus notices, if FSA were to regard those as giving rise to an expectation of how the GAR would be applied, then a similar question would need to be asked concerning the level of bonus indicated. A manuscript addition on the final point by a prudential division officer said "*Yes but an indication (false) has been given*". GAD offered three options:

(a) The final bonus [at the level illustrated] could be regarded as binding in all circumstances; they doubted that a reasonable policyholder could interpret the illustrations as providing an absolute guarantee in all circumstances, and said that such an interpretation would have severe consequences for the whole industry, with many companies being unable to meet the resulting increase in liabilities.

(b) The [illustrated level of] final bonus could be regarded as variable, but only in line with underlying investment conditions (which they said was more plausible). If it were held that that level of bonus was the expectation of holders of policies containing GARs, in the current investment conditions the result for Equitable could amount to an increased cost of £2bn. They would lose their reinsurance cover but would just remain technically solvent and would have to recoup the £2bn from other [non-GAR] policyholders, which could be commercially damaging and could impact on those policyholders' expectations. Their position as a mutual would become almost untenable, and they could be expected to argue that FSA had signed their death warrant.

(c) The bonus could be regarded as variable, subject only to smoothing over a reasonable period of time. Equitable would remain solvent but would be weakened both commercially and financially.

GAD said that, overall, they would be inclined not to intervene in such circumstances, but that FSA might see some attractions in option (c).

25/06/99
The prudential division prepared a paper on action FSA might need to take if the court did not give a substantive view on policyholders' reasonable expectations. They said that the legal division had advised that the test to be applied was whether it was reasonable to consider Equitable's approach consistent with policyholders' reasonable expectations, rather than whether they were adopting the best possible approach in that context. They did not consider it practical to reach a view on policyholders' reasonable expectations ahead of the court judgment, though they would undertake more work on that issue so as to be able to reach a view soon after judgment was given. They should flag up to Equitable at a forthcoming meeting that policyholders' reasonable expectations remained a live issue, lest Equitable were to infer from their silence that they were content. They said that the format of Equitable's bonus notices, which appeared liable to lead policyholders to unrealistically high expectations of their payout, were currently the main factor in support of the argument that Equitable's approach was not consistent with policyholders' reasonable expectations. They had raised this with the conduct of business division, and asked if PIA had the power to require changes to be made to the bonus notices. The prudential division had themselves previously raised that matter with Equitable (before the GAR issue arose) but had not made any progress in obtaining changes.

Equitable replied to GAD's letter of 27/05/99. They explained why they considered it appropriate to assume a lower level of take-up of GAR options than required under the guidance. They said that the reinsurance offset had been calculated on the assumption that any guaranteed benefits taken in GAR form above 25% would be covered by the reinsurer and paid back from future surpluses. With regard to questions that had been asked about their

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regulatory solvency projections, they said that the required level of reserves appeared low in proportion to their projected cashflow, because the latter item included both linked and non-linked business, whereas the item relating to reserves related only to non-linked business. They confirmed that there had been no material change in the valuation bases. The further scenario that GAD had asked them to apply to their projections would result in a ratio of available assets to minimum margin, at the end of 1999, of 1.4:1, assuming a declared bonus at $^1/_2$% below that for 1998.

28/06/99
GAD responded to the prudential division's note of 25/06/99, saying that they felt that PIA and/or the Ombudsman might have a greater role to play if there was any suggestion of mis-selling by the salesforce. They also copied to them Equitable's letter of 25/06/99.

29/06/99
Equitable met FSA's prudential division and GAD. A note of the meeting prepared by the prudential division recorded that Equitable had said that their lawyers considered it very likely that they would win the legal action, though perhaps with some adverse comment (the first and second of the outcomes considered in their letter of 21/06/99); they saw the final outcome listed, whereby final bonus rates had to be equalised for both cash and annuities at the cash level, as "*inconceivable*", as they did not believe that a judge could totally discount the scope of directors to exercise discretion over bonus levels. Equitable had not implemented any of the mechanisms for strengthening their position that had been discussed in the Board paper copied to the prudential division on 20/04/99. Equitable said that none of the first four outcomes listed in their letter would require a change to their bonus practice, and so invalidate the reinsurance. They believed that it would be possible to extend the scope of the treaty, should they lose the case. GAD pointed out that any extension to the scope of the treaty could have implications for Equitable's future profit implicit items. The prudential division pointed out that even were Equitable to win, that would not be the end of the matter as far as the regulator was concerned, because they would still need to consider whether Equitable's bonus policy was consistent with policyholders' reasonable expectations. They added that they had some concerns about the information contained in the bonus notices, but had not yet reached a view on that.

Equitable said they had adopted a new bonus payment approach which had been recommended by their legal advisers. They now paid an additional cash sum to policyholders who did not exercise a GAR option [as opposed to a reduction in the bonus payment to those who did]. They agreed to provide the prudential division with copies of the relevant information provided to policyholders. Equitable said that they would continue to offer good value to policyholders by paying out as much as possible in bonuses and not building up any hidden estate. They said that a lack of estate was a useful deterrent against predators, though that was secondary to Equitable's main historical objective, which was to pay out fair shares. Equitable said that they had been approached by a number of suitors, but their reply had been that they were committed to mutuality.

30/06/99
Equitable sent FSA's prudential division an example of a bonus notice for 1998, which they passed on to the conduct of business division for their views on whether or not it was misleading. Equitable also sent a copy of a letter dated 29/06/99 to policyholders about the court case.

02/07/99
The legal division told the prudential division that their paper of 25/06/99 had inaccurately described the advice that the legal division had given concerning the approach to be taken in determining policyholders' reasonable expectations. However, the prudential and legal divisions had since agreed the steps needed to reach a decision on those expectations.

The prudential division replied to the letter of 18/06/99 from Equitable's solicitors confirming that the supplemental agreement relating to the subordinated loan did not require alteration to the 18/08/97 section 68 order.

05/07/99
The hearing began in the High Court. Equitable's solicitors sent the prudential division copies of the skeleton arguments.

The prudential division sent FSA's managing director and the conduct of business division a note outlining some of the background to the legal action. They said that FSA would need to consider the impact of the judgment on Equitable's financial position and, unless the judgment were to settle the matter definitively, to undertake a significant exercise to determine whether they should intervene to ensure that Equitable's approach was consistent with policyholders' reasonable expectations. They set out a list of questions which would need to be addressed when considering the issue and said that they might have to invite representations or additional evidence from policyholders before reaching a final view. They did not expect the judgment to impact on the level of reserves Equitable needed to cover their liabilities to policyholders. They said that Equitable were co-operating fully with them over the issue.

The prudential division attached a document setting out three possible outcomes to the legal action, and analysing the implications of each both for Equitable and for FSA. Should Equitable win, they would continue with their current practice in respect of terminal bonuses and would remain solvent, though relatively weak. FSA would need to continue to monitor closely Equitable's solvency and decide whether there were grounds for intervention on the basis of policyholders' reasonable expectations, or whether the court ruling should be considered definitive. Under the second scenario, where Equitable won in part

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(their current bonus practice was judged acceptable but past practice was not), Equitable would have to pay compensation to some policyholders, though the cost was unlikely to be substantial relative to their reserves (perhaps £400m). There could also be a downgrading of their credit rating, with resultant reputational damage. The implications under this scenario for FSA were much as for the first, with the additional need to review their guidance in the light of the judgment, and to consider the implications for other companies that had adopted a similar practice. The third scenario considered was one where the court ruled that Equitable could not reduce the terminal bonus for policyholders choosing to take a guaranteed annuity. The reinsurance would then be invalid, though Equitable had established that there was scope for replacing it; should that not be possible Equitable would only just cover the required minimum solvency margin after taking full account of future profit implicit items. They would need to consider a drastic reduction in terminal bonus payments to policyholders with GAR options, irrespective of whether or not those options were exercised or, if that was not acceptable to the court, a reduction in bonuses for all with-profit policyholders. Equitable would aim to cut bonuses gradually over three years to meet policyholders' reasonable expectations, which might precipitate a takeover bid or a reduction in business. The prudential division would need to determine the company's solvency position and, if the required minimum margin was breached, to require a short-term scheme for restoration of a sound financial position. Even if the regulatory solvency margin were not breached, the prudential division would need to obtain financial projections, along with a plan for strengthening the position in the short to medium term. If there were a significant risk that Equitable would be unable to meet their liabilities to policyholders, consideration would have to be given to closing the company to new business or suspending their authorisation. Close monitoring of the company's business would be required. The prudential division would also need to assess the consistency of speed of bonus reduction with policyholders' reasonable expectations; perhaps to encourage Equitable to look to reducing surrender values relative to maturity values; and to be alert to the potential for a wider loss of confidence across the industry. They would need to monitor surrender values, to see that they were not so generous as to adversely effect the solvency position, and to address concern that policyholders were losing out through early surrenders. They noted the potential for allegations that FSA should have prevented Equitable from writing new business earlier.

06/07/99
FSA's prudential division sent a holding reply to Equitable's request for a section 68 order for a future profits implicit item for the year to December 1999.

07/07/99
FSA's Executive Committee suggested that the prudential director circulate the 05/07/99 note on Equitable and the possible consequences for FSA.

15/07/99
The managing director told the FSA Board that the test case on Equitable's handling of GARs had begun. The legal position was, however, complex and it seemed unlikely that the court would resolve all the issues. The prudential division were undertaking some contingency planning.

GAD told Equitable that they would defer consideration of the justification that the company had provided for their assumptions as to the proportion of policyholders who would take guaranteed annuities until they had seen the outcome of the court case. They added, however, that they had some difficulty in accepting that reductions of between $17^{1}/_{2}$% and 30% [see 30/03/99] were consistent with the "*few percentage points*" quoted in guidance note DAA11 [13/01/99].

19/07/99
Equitable replied challenging GAD's interpretation of guidance note DAA11. They said that there were a number of factors in respect of which the requirement to assume 100% take-up of GAR options might be relaxed. They contended that the reduction of "*a few percentage points*" should be applied to each factor individually, rather than to the combined effect of them all. They went on to say that the guidance referred to the allowance being a few percentage points of the reserve, rather than of the assumed take-up rate; that meant that even where they had assumed a take-up rate of 70%, the reduction in the overall reserves was less than 10%. [GAD and the prudential division did not dispute this interpretation as the existence of the reinsurance agreement meant that reserving at the higher level would not affect Equitable's net liability.]

27/07/99
The third quarterly meeting between the Treasury and FSA's prudential division took place. GARs were discussed, but Equitable was not mentioned.

11/08/99
At their third bilateral meeting the prudential and conduct of business divisions discussed progress with the Equitable court case. The prudential division said that they had transcripts of the entire hearing and had prepared summaries. They said that the judgment was expected on 09/09/99 and that the case could go either way.

12/08/99
The prudential division's summary of the court case was circulated within that division and sent to the legal division and GAD. In a covering memo, which was copied without attachments to the conduct of business division, the prudential division said that while the case could go either way, the most likely outcome was that Equitable would win, but with some criticism that they had not made their bonus practice clear to policyholders. Equitable's Counsel had argued that policyholders' reasonable expectations would not be met for those without GARs if they did not receive their asset share because they had to meet the cost of paying GAR policyholders more than their asset share.

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A manuscript note by FSA's legal adviser agreed that the result of the case was impossible to call.

17/08/99
GAD wrote to all life insurance companies about proposed revisions to regulations and to the resilience tests.

27/08/99
Equitable responded to the consultation exercise on proposed changes to regulations and to the resilience tests. Equitable said that the consultation had implied that the proposed changes to resilience test 2 were intended to make it less severe; however, for a company with a mix of fixed interest assets across all durations they did not believe that the changes would have that effect. They believed that the revised regulations and, in particular, the revised resilience tests were likely to lead to the need for substantially higher reserves.

31/08/99
In reply GAD said that they were puzzled by some of Equitable's comments. They suggested that companies could arrange their investments in such a way that they could be reasonably resilient to the investment changes postulated in the revised test 2.

c31/08/99
The prudential division prepared a risk assessment of Equitable as part of piloting a new approach to company assessment. This suggested that Equitable should be seen as a high financial risk because of the level of benefits guaranteed to policyholders, the relatively low free asset position and the difficulty they would face in raising external finance. They would be particularly vulnerable to a sustained and significant fall in equity prices or other changes in economic circumstances. Equitable presented low organisation, strategic and management risk and appeared well managed and efficient; there was a need, however, to obtain more information, particularly about systems and controls. Environmental risk was regarded as low, though there was some reputational risk as a result of the dispute over how the costs of GAR options were met. Equitable's cultural attitude was said to tend towards "*arrogant superiority*" which, it was suggested, could blind them to the financial risks of guaranteeing high benefit levels. They were said, however, to be open with the regulator, who had no particular concerns about the level of co-operation. They generally had a good record of compliance with FSA's prudential and conduct of business divisions. Equitable had taken heed of regulatory concerns about the level of reversionary bonuses and had made some effort to reduce them. Further reductions would be needed in future years if the risk was to be significantly reduced. They had a high exposure to GAR options, for which a reserve of £1.5bn had been established, and it was arguable that a higher reserve should have been set. About half of the reserve was covered by reinsurance which was needed to show a reasonably healthy level of free assets. Equitable could need to pay compensation to GAR option policyholders if they lost the court case. A marginal note commented that Equitable's "*strong reputation*" in the insurance market was "*already tarnished*".

08/09/99
FSA's Executive Committee noted that the Equitable judgment was expected on the following day and that FSA would need to consider how to respond.

Equitable replied to GAD's letter of 31/08/99 about the proposed changes to the resilience tests saying that they still disputed the assertion that the new test 2 (coupled with the new reinvestment formula) was less severe than the old.

09/09/99
A private sector rating agency affirmed the credit and financial strength ratings on Equitable as A+ [a reduction from the AA rating of 29/04/98]; they said that the outlook was stable.

The High Court ruled that Equitable were entitled to operate their differential terminal bonus policy. Mr Hyman was granted leave to appeal.

GAD told FSA's prudential and legal divisions that they had seen nothing in the judgment that was inconsistent with the general guidance which FSA had issued on the application of GARs and the terminal bonus. However the judgment had clearly suggested that policyholders' reasonable expectations might extend further than contractual rights. FSA might need to consider intervening in respect of those policyholders whose expectations may not have been met, though the numbers and amounts involved were likely to be quite low.

10/09/99
FSA's legal division provided the prudential division, the managing director and GAD with a summary of the judgment and a brief outline of the implications for FSA. They said that the judgment provided the first real judicial support for the principle that policyholders may have a reasonable expectation of benefits over and above those contractually guaranteed. GAD's comment, that it appeared not to affect FSA's guidance on reserving, was noted. The judgment had described the factors that might shape policyholders' reasonable expectations. Those factors, which had been agreed by expert witnesses, were: the terms of the contract with the policyholder; statements made to policyholders by the company; past practice of the company; and practice in the industry. The legal division said that they would not take issue with any of that and commented that it was useful support to FSA policy. The court had found that Equitable's practices and their communications with policyholders had produced a reasonable expectation among holders of policies containing GARs that the guaranteed rate would be applied to the full and unadjusted terminal bonus. The legal division said that, on the evidence that they had seen, FSA would be likely to come to the same conclusion. The court had taken the view, however, that policyholders' reasonable expectations did not become a contractual right and was only one of a number of factors that the directors had to take into account when exercising their discretion; the balance between that and other factors was a matter for them and not for the court. The legal

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division said that they did not find that conclusion surprising. While the court had found that the directors had properly had regard to policyholders' reasonable expectations, [albeit that they had not then fulfilled those expectations] the legal division said that the question for FSA went beyond that; they would have to consider whether sufficient or due regard had been paid to the concept and whether to take action under section 45 of the Insurance Companies Act to ensure that the criteria of sound and prudent management were fulfilled. They said that those criteria included: carrying on the business with integrity; and conducting business with due regard to the interests of policyholders. Were they then to conclude that due regard had not been given to policyholders' reasonable expectations, there would be "*a real awkwardness*" in taking action, in part because of the need to rely on grounds primarily directed at good management, soundness and prudence, rather than conduct of business. It was noted that the prudential division had decided to defer a decision on taking action until the appeal had been concluded. It was also noted that FSA had some evidence that, when discussing options with policyholders on maturity of the policies, Equitable had not told policyholders that the terminal bonus was conditional. The legal division said that that was not a matter for the prudential division and was before the PIA.

The prudential division copied the memo to the conduct of business division and Treasury.

13/09/99
An internal conduct of business minute said that they had held a low profile on this important case and as a consequence had not fully investigated the scope of the problem. Statements to customers about pre-FSA business were not within their scope, although the giving of any misleading statements at maturity of a policy could be within the scope of the PIA. However, if the judgment held, then that would be less likely.

14/09/99
FSA's Executive Committee discussed the judgment and its implications [there is no record of what was said].

The prudential division noted that the conduct of business division would wish in due course to consider whether Equitable had misrepresented the GAR policies, although their scope for action was likely to be limited as those polices had generally been sold pre-1988.

In an internal e-mail, copied to the prudential division, the director of FSA's conduct of business division referred to the legal division's memo of 10/09/99 and said that he was puzzled by the reference to the question of Equitable's advice to policyholders being before the PIA, as he understood the contracts in question to have been sold before 1988. He said that he was therefore unclear as to whether PIA had any standing in the matter and he asked the conduct of business division to consult the legal division and enforcement team to establish what they should be advising PIA to do. He said that, if they were to investigate, they should probably not await the outcome of the appeal since none of the points at issue in the litigation would seem to bear on whether Equitable's communications were compliant.

15/09/99
The director of the prudential division, to whom the above had been copied, told the conduct of business director that he was keen to look at the issues from the perspective of all the FSA constituent bodies, and to consider any possible action in the same way. He said that that would probably mean that they should not decide on any action until the appeal court's decision was known. If the judgment were overturned it was possible that action would be warranted under the Insurance Companies Act, and he wanted to avoid a situation where such action might be constrained or prejudiced by earlier action by others. The prudential director said that they could consider the matter further in the light of an analysis that they had agreed should be undertaken while the appeal was pending.

16/09/99
Equitable told all policyholders that the court had approved their bonus practice.

FSA's managing director told the FSA Board that the Equitable judgment might have wider consequences for interpreting policyholders' reasonable expectations. The Board noted the position.

20/09/99
The prudential division asked GAD when they expected to complete their scrutiny report on Equitable's 1998 regulatory returns. GAD replied that the report had been submitted to FSA on 20/05/99. They said that two matters had been outstanding at that stage. Those were the final wording of the reinsurance treaty - which they said they had yet to see - and a decision as to whether to challenge some of Equitable's assumptions in setting reserves for GAR options. They said that no formal consideration had yet been given to the points raised in Equitable's letter to them of 19/07/99 (in which they had attempted to justify assuming a lower take-up for GAR options than was required under the guidance).

The prudential division wrote to Equitable outlining the proposed agenda for a company visit that they intended to make in December, as part of the standard three yearly cycle of visits, to discuss Equitable's overall position and future plans. They said that they would be accompanied by GAD. They listed the areas that they would expect to cover during the visit as: overview of corporate management structure; general market outlook and business strategy; marketing approach; the role of the appointed actuary; systems and controls; and investment policy and asset management. [The letter was not copied to the conduct of business division.]

In an internal memo, copied to the prudential division, the conduct of business division set out what they saw as the implications of the judgment for the PIA rules. They said

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that there was little that they could do about what GAR policyholders might have been told when buying their policies as most, if not all, such policies had been sold before 29/04/88 (when the relevant rules came into effect). Though it had been suggested that some guarantees had been given after that date, they had seen no evidence of that. When a policy matured, it would be incumbent upon the company (or the independent adviser where appropriate) to advise the policyholder of all available options, and of the consequences of each. Leaving aside the question of companies offsetting the value of a guarantee against the terminal bonus, they said that they had no evidence to suggest that policyholders were being wrongly advised at that stage. The prudential division had queried whether certain bonus notices were in breach of conduct of business rules. They said that, historically, they had not considered bonus notices to fall within PIA's jurisdiction, because that jurisdiction was concerned only with selling and marketing, whereas bonus notices were considered to be part of a company's administrative functions. However, PIA Rule 4.1 said that any communication must be clear, fair and not misleading. While it was not clear that that would extend to bonus notices, they said that they had reviewed Equitable's bonus notices for 1997, 1998 and 1999, and had concluded that there was nothing seriously wrong with them. They proposed a meeting with the prudential division and others with an interest [held on 21/10/99] to discuss next steps.

23/09/99
In a memo to the prudential division, the conduct of business division said that they did not consider Equitable's bonus notices to be poorly presented or inaccurate and did not therefore intend to take action under Rule 4.1 of the PIA rules [see previous paragraph]. They went on to say that they had not previously taken such action in respect of documents issued once post-sale information had been provided, since the ongoing servicing of policies did not seem to fit comfortably with their remit. They would therefore have to have serious concerns about a document before taking action against a company in such circumstances. The prudential division noted in manuscript at the foot of the memo "*A surprisingly unqualified endorsement for the bonus notices*"; they copied it to the legal division and to GAD.

24/09/99
GAD advised the prudential division in respect of Equitable's application of 30/03/99 for a future profits implicit item of £1bn. They confirmed that the calculations provided were in line with the guidance and that the company's estimate of future profits appeared to be fair. The sum applied for was only about one third of the sum for which Equitable could have applied, and was substantially less than they had been allowed in 1998. GAD had no real doubts that the sum could be reasonably accepted by FSA. They went on to say however that, as some element of future surplus had been assumed to be used to pay part of premiums arising under the reinsurance treaty, Equitable should be asked for confirmation that that would not adversely affect their application. GAD suggested a form of words to be used, and said that they were confident that the company would be able to provide such confirmation. They suggested that the prudential division ask for a copy of the treaty as finally signed. They enclosed a copy of Equitable's letter of 19/07/99 (about the assumed rate of take-up of guaranteed annuities) and said that they were not inclined to take the matter further at that time. Though they remained somewhat uncomfortable that Equitable's reserving assumptions were not fully in line with guidance note DAA11, the reinsurance meant that while assuming a higher take-up rate of GARs would increase Equitable's gross liability, their net liability would remain unchanged. They suggested that the matter might be discussed again at the proposed FSA visit. GAD concluded that their detailed scrutiny of the returns was now closed.

28/09/99
FSA's prudential division wrote to Equitable on the lines suggested by GAD. They said that they could not recommend approval of a section 68 order for a future profits implicit item for 31 December 1999 until they had received the requested further confirmation regarding the reinsurance. They also asked to see the final signed reinsurance agreement.

30/09/99
The reinsurer signed the reinsurance agreement.

10/99
[According to the Baird report, around this time the FSA's enforcement team reported the results of the investigation they had begun on 22/06/99 into Equitable's sales of pension fund withdrawals. The report was copied to the conduct of business division on 14/01/00.]

01/10/99
GAD told the prudential division that they believed the High Court's judgment had been more favourable to Equitable on policyholders' reasonable expectations than the legal division had implied. They believed that the judgment had indicated that sufficient or due regard had been, and continued to be, given to policyholders' reasonable expectations.

11/10/99
At their fourth bilateral meeting, the prudential division set out the implications of the judgment both for themselves and for the conduct of business division. They said that in their view, although Equitable had had regard to policyholders' reasonable expectations, they had not met them, so there was the possibility of intervention. In terms of conduct of business issues, misleading bonus notices may have been provided or companies may have moved policyholders into new contracts without guarantees.

14/10/99
Equitable sent the prudential division a revised application for a section 68 order for a future profits implicit item of £1bn as at 31/12/99, confirming they had taken full account of the reassurance arrangements. They also

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enclosed a final signed version of the reinsurance treaty which had been signed by Equitable on 11/10/99. This said (as had the February 1999 draft) that if claims exceeded £100m at any 31 December, negotiations would take place to find a mutually agreeable restructuring of the treaty to include a redefinition of the adjustment premiums in respect of future years.

c14/10/99
FSA's prudential division sent the reinsurance treaty to GAD, asking them to check it and confirm that they could now allow Equitable's application for a future profits implicit item.

21/10/99
FSA's prudential, conduct of business, legal divisions, the conduct of business policy team, and the enforcement team met to discuss what action PIA should be taking in respect of the guaranteed annuity issue generally, and Equitable in particular. In a note to GAD, the prudential division said that, in relation to Equitable, PIA were likely to conclude that they did not have powers to take action in respect of misleading bonus notices "*(if they were misleading)*" as bonus notices were probably outside their remit. They wanted to establish whether sufficient GAR policies fell within their remit to justify an investigation (should they consider there to be grounds to launch one) into the sales process. To that end, the prudential division would write to Equitable asking them how many GAR policies they had sold after April 1988, and the number of top-ups sold since June 1988 (when Equitable stopped selling policies with GAR options). In relation to other companies, they said that PIA would consider looking at whether there were any companies that had sold a significant number of such policies after 1988 and what their practices had been. They asked GAD to collate the relevant information from the results of the 1998 survey.

The managing director told the FSA Board that FSA would await the outcome of the appeal in the Equitable case before considering whether further action was called for. A review of resilience testing, which he said had been reported to the Board in September, had been made more urgent by the desirability of having a little more flexibility in the rules, ahead of what could be volatile and thin markets around the end of the year. Revised guidance had now been issued.

In preparation for their meeting arranged for 26/11/99 the prudential division asked the other regulators involved with Equitable for information to be used in preparing a draft Overall Assessment and Co-ordinated Supervisory Programme.

22/10/99
GAD told the prudential division that the confirmation that Equitable had provided in their letter of 14/10/99 was as they had requested, and the application for a future profits implicit item of £1bn was therefore acceptable. They added that the signed reinsurance agreement was totally in accord with the draft examined in detail in April 1999.

27/10/99
Responding to the prudential division's request of 21/10/99, the conduct of business division said that their risk rating for Equitable was average; the last visit had taken place in June 1998, at which time there had been no outstanding issues; the latest activity had been tracking the guaranteed annuity case; the next visit was planned for the second quarter of 2000; and that they "*Aim to meet Compliance Management before end Q4 1999*".

29/10/99
FSA's prudential division asked Equitable for details of policies containing GAR options sold after 29/04/88, and of top-ups made after the same date.

03/11/99
The prudential division recommended to the Insurance Supervisory Committee that Equitable's application for a section 68 order for £1bn of future profits to be treated as an implicit item to count towards regulatory solvency be granted. They said that, while there was some debate at the margins between Equitable and GAD about the reserves required for GAR options, the prudential division were generally satisfied that Equitable were adequately reserved for their exposure to GAR options, which had "*been largely offset*" through reinsurance. The court judgment was subject to appeal and it was possible that further cases might arise in the future in relation to Equitable's differential terminal bonus policy. They said, however, that that should not affect Equitable's financial position since the regulations required them to reserve fully for all policies containing a GAR option. Equitable could have qualified for an implicit future profits item of almost twice that sought. GAD had reviewed the calculations and were content that the concession should be granted.

08/11/99
The Insurance Supervisory Committee approved the application for a section 68 order without further discussion.

09/11/99
The Treasury issued the section 68 order.

10/11/99
Equitable told FSA's prudential division they would have no difficulty establishing the number of GAR option policies sold between 29 April and June 1988, but asked for clarification of what was meant by "*top-ups*" since, they said, the flexibility of their policies meant that there were a number of events that might be so called. They also pointed out that policyholders making top-up payments would generally do so on the basis of independent financial advice or on their own initiative, rather than on the basis of advice from Equitable.

11/11/99
In response to the prudential division's request of 21/10/99, GAD identified seven companies, including Equitable, whose possible exposure to GAR options suggested further investigation by PIA.

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The fourth quarterly meeting took place between the Treasury and FSA's prudential division. Equitable was not discussed.

15/11/99
FSA's prudential division wrote to Equitable asking for information required to prepare for the planned supervisory visit.

17/11/99
In preparation for the forthcoming meeting of the regulators on 26/11/99, FSA's prudential division produced an overall assessment of the Equitable Life Group. They said that the group was deemed medium to high risk. That rating was predominantly influenced by Equitable's financial position and exposure to GAR options. No particular problems had been identified by PIA, which had assessed both of the firms that they supervised [i.e. Equitable and Equitable Unit Trust Managers Ltd] as average risk. The prudential division had been monitoring Equitable's exposure over pensions mis-selling, and were reasonably confident that they had adequately reserved for that exposure, which was not large enough to be of material concern for them. The Investment Management Regulatory Organisation (IMRO) had significant concerns about Equitable's compliance with their requirements and had put them on a high risk monitoring cycle. Both IMRO and the prudential division had identified concerns about Equitable's attitude to regulation, and the prudential division had concerns over their "*slight institutional arrogance*" about being a mutual. The paper set out Equitable's financial position, including reference to the relatively low free assets; traditionally high levels of bonus; the use of future profits implicit items and subordinated debt; the high level of exposure to guaranteed annuities; the reliance on reinsurance; and the potential for Equitable to have to pay compensation should they lose at appeal. The paper said that Equitable had gone too far in distributing surplus to policyholders, to the extent that they were dangerously under capitalised and exposed to a market downturn. Furthermore, while they were not alone in being caught out by the GAR issue, they had not woken up to it quickly enough, and communication to policyholders of their change in policy in relation to bonuses had been decidedly unclear and had left them open to criticism.

18/11/99
The managing director told the FSA Board that the Court of Appeal hearing was set for 29/30 November.

24/11/99
The prudential division produced a paper addressing the issue of what proportion of policyholders might reasonably be assumed, for reserving purposes, not to exercise a GAR option. They said that a decision was required at the Insurance Supervisory Committee meeting of 06/12/99. They considered that 5% was the maximum proportion of policy proceeds that companies could prudently assume would be taken in non-guaranteed form. That equated to an assumption that 20% of policyholders would opt to take the maximum tax free cash sum (which was 25% of the total fund value) and take the rest of the benefits as a guaranteed annuity. It was clear from the 1998 regulatory returns that a number of companies had interpreted the Government Actuary's guidance as permitting an assumption that 10% of policy proceeds would be taken in non-guaranteed form. The prudential division thought it unlikely that companies that had reserved on that basis would then raise strong objections to being told to increase their provision for GARs from 90% to 95%. Equitable, however, might raise more of an objection, since they had reserved in 1998 at 80% and were known to consider even that as excessively prudent. Because of the reinsurance, Equitable's solvency position would remain unchanged were they to be required to reserve to 95%, although they would then appear to have a higher gross liability and to be more reliant on the reinsurance than they would like.

25/11/99
Equitable sent the prudential division a substantial volume of information in preparation for their visit. Instead of a financial condition report, Equitable sent financial projections dated 23/04/99 and a Board report of 22/10/99 on revenue and solvency matters.

26/11/99
The prudential division forwarded Equitable's reply of 10/11/99 to the conduct of business division. They said that it was PIA's definition of top-up that was relevant, rather than their own, and they asked for advice as to how they should respond. They also asked whether PIA still needed to know how many top-up payments had been made, given that Equitable had said that such payments would not normally follow advice from the company. [PIA did not respond to the prudential division or to Equitable.]

FSA's prudential division sent Equitable a draft agenda for their 06/12/99 visit which did not refer to GARs. They confirmed that they had received from Equitable the skeleton arguments for the appeal.

The meeting of regulators responsible for Equitable took place. FSA's prudential division and IMRO were present, but the conduct of business division sent their apologies. IMRO said that in their experience Equitable's regulatory history was poor; they had received warnings and breached rules. Compliance was weak, under-resourced, inexperienced and out of touch with the business. It was a high risk area and on a ten month visit cycle. However, they also reported efforts that the company was making to improve the situation. The prudential division reiterated the points raised in their overall assessment (of 17/11/99). It was agreed that the prudential division would update both the overall assessment and the co-ordinated supervisory plan after their visit to Equitable.

29/11/99
The appeal hearing opened.

01/12/99
The Tripartite Standing Committee discussed whether the resilience tests were still appropriate in the light of lower

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interest rates. There was also some discussion of what role, if any, the regulator had in managing concentration in the industry. It was suggested that FSA could make it clear to troubled firms that they should take action to resolve their problems sooner rather than later.

02/12/99
Appeal Court hearings in open court finished.

03/12/99
Equitable told the prudential division that they had written 22,224 GAR policies between 29 April and 30 June 1988, after which such policies were no longer offered. They said that exceptional levels of business had been generated by the imminent withdrawal of the product. As Equitable had only 300 sales staff it was likely that most of those buying policies at that time would have done so on their own initiative, rather than on the advice of one of the company's representatives.

06/12/99
FSA's prudential division and GAD visited Equitable as part of their three yearly cycle of company visits. There was some limited discussion of the GAR issue (FSA have said that the purpose of the meeting was to discuss issues other than GARs or the court case, which were already receiving adequate attention). Equitable said that the reinsurance scheme had been extended to cover group business as well as individuals. That meant that the net liability to Equitable, which had reduced as a result of the reinsurance from £1.56bn to £760m, would reduce further to £560m. That liability would further decrease over the following year when some 10% of GAR business would come off the books. The prudential division said that FSA and the Government Actuary would be writing to the industry before the end of the year explaining more clearly the approach that they expected to be adopted to reserving for GARs; that could result in a need for Equitable to increase their reserves. Equitable confirmed that that would not impact on the reinsurance treaty. They recognised that their declared bonus rates would have to be further reduced if the current level of investment return persisted, though they proposed to pause before making further cuts to see if yields would improve. They said that if declared bonuses remained at 5%, terminal bonuses were likely to increase as they would otherwise be allocating less than they had earned in the previous four years.

07/12/99
In response to a query to the FSA helpline about a policy which had been taken out in 1983, the conduct of business division said [inaccurately for those joining between late April and June 1988] that the guarantees were given well before the 1986 Act came into force and that their current rules re disclosure and "*clear, fair and not misleading*" did not therefore apply.

10/12/99
The prudential and conduct of business divisions held their fifth bilateral meeting. The prudential division said they had now received information from Equitable on the numbers of policies sold after April 1988, which they would pass to the conduct of business division.

16/12/99
The managing director told the FSA Board that the appeal against the judgment in Equitable's court case had been heard, but that it was not yet known when judgment would be given.

16-22/12/99
The prudential and legal divisions discussed with GAD further draft guidance to companies on reserving for GAR options.

20/12/99
The prudential division told Equitable about the enhanced lead supervision arrangements that FSA would introduce by June 2000. Lead supervision for Equitable would start immediately. The prudential division, as lead supervisor, would maintain an overall assessment of Equitable; produce a co-ordinated supervisory plan; and act as a central point of contact for group wide issues - ensuring that information which was relevant to more than one entity reached relevant parts of FSA. They pointed out, however, that they were not the sole point of contact and would not seek to interfere with existing supervisory relationships.

22/12/99
The Government Actuary issued further guidance (DAA13) on reserving for GARs. He said that having reviewed most companies' returns for 1998, some inconsistency was apparent in the way that companies were interpreting the guidance issued on 13/01/99. Clarifying the term "*a few percentage points*" used in the earlier guidance, he said that that referred to the total aggregate allowance that might be made for all other forms of benefit (whether cash or other forms of annuity) and should not exceed 5%. He said that it would not be prudent to assume that more than 20% of policyholders would choose to take the maximum cash lump sum, which in the case of most pension contracts would equate with a 5% reduction in reserves.

FSA's prudential division wrote to the managing directors of all life insurance companies enclosing copies of the Government Actuary's letter (the original having been sent to companies' appointed actuaries), asking to be told if companies foresaw any difficulties in complying with the guidance.

2000

12/01/00
The prudential division provided the conduct of business division with the information that they had received from Equitable about the number of GAR policies sold between April and June 1988. The prudential division said that as few of the sales would have been advised by Equitable, and those would be difficult to identify, it was arguable that the conduct of business division could justify not taking the matter further. They pointed out that Equitable's

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query on the definition of a top-up remained outstanding, and that in view of the small number of such transactions that would have been advised, they would need to decide whether the matter was worth pursuing.

14/01/00
The FSA director, in a weekly report to the managing director, said that the Court of Appeal's judgment was now expected on 21/01/00. The prudential division had informed the Debt Management Office and the Treasury.

21/01/00
The Court of Appeal gave judgment against Equitable by a majority of two to one. The Court ruled that the discretion afforded to the directors of Equitable by article 65 did not allow them to allot a lower level of bonus simply because an individual policyholder had exercised a right to a GAR. One of the judges who had found against Equitable, however, went on to say at the end of his judgment (in a comment which did not form part of his reasoned decision) that it was legitimate in his view for the Board to have regard to the value of the notional asset share of the different policyholders; he therefore saw no reason why Equitable should not award different bonuses to different types of policyholder and set bonuses for those who had GARs at such a level as not to deprive those who did not [a practice referred to as ring-fencing]. He said that it was possible that that would result in those policyholders who had GARs not doing very much better in cash terms than they had done previously.

Equitable faxed their solicitors' summary of the judgment to the prudential division, who forwarded it on to GAD. On the basis of that document GAD prepared their own assessment, which they sent to the prudential division the same day. They said that most of the advice contained in the guidance issued by the Treasury on 18/12/98 remained valid; in particular, they noted that the guidance had been consistent with the judge's view that bonus levels could be reduced for policyholders with GAR options as a class. They also said that the judgment vindicated the prudential division's position on the necessary reserving levels, which would now be even more appropriate as the judgment meant that there was less incentive for policyholders to forego GARs. While Equitable might have to increase benefits for those who had already taken GARs, so that all such policyholders were treated equally, GAD noted that the cost should be fairly marginal as the level of bonus might be reassessed, thus minimising the increase in annuity benefits, and few policyholders had elected to take the guaranteed rate. They suggested that Equitable be asked to confirm that the judgment did not affect the reinsurance agreement.

FSA's prudential division told the managing director that Equitable had been granted leave to appeal to the House of Lords and that the Court of Appeal's judgment had been suspended until that appeal had been heard.

The prudential division told the conduct of business division that the judgment gave no cause for panic. The judgment was now subject to appeal and the court had allowed Equitable to continue with their practice for determining bonuses pending that appeal. They said that the publicity was likely to dent Equitable's sales, but their reserving requirement would not be affected and so their financial position would be largely unaltered.

22/01/00
FSA's chairman asked whether there was any substance to the media comment that others in the industry thought that FSA had been "*indulgent*" towards Equitable.

01/00
Equitable continued to advertise and to advise consumers to invest in their with-profits fund.

24/01/00
FSA's prudential division told the other relevant regulators that Equitable had been granted leave to appeal to the House of Lords. They said that they did not believe that the judgment would greatly affect Equitable's statutory financial position, as they had already had to reserve fully for GAR options. However, the judgment was a severe blow for Equitable, and was likely to dampen sales and increase uncertainty.

25/01/00
FSA's Executive Committee met and were told that the prudential division were considering the Equitable judgment.

26/01/00
The prudential division asked GAD for information from the survey that they had carried out in 1998, to ascertain whether companies, other than three which they named, were taking an approach to GARs similar to that taken by Equitable. GAD replied that one additional company was taking a similar approach, while replies from others were unclear on the point. GAD suggested writing to all with-profits insurers to clarify the position.

27/01/00
The director replied to the FSA Chairman's query of 22/01/00. He said that one of the appeal judges had referred to the Treasury's guidance letter to life companies of 18/12/98 (wrongly) as "*HMT 'endorsing' the Equitable's position*" which may have prompted the comment. In reality, however, a number of companies, including Equitable, believed that FSA had taken a very tough line with them on reserving standards.

28/01/00
FSA's prudential division prepared a preliminary assessment, for internal circulation, of the implications for the insurance industry if the House of Lords were to uphold the Appeal Court's judgment. They pointed out, however, that there was every possibility of the Court of Appeal decision itself being overturned and/or the House of Lords putting forward different arguments as the basis of their decision. The Court had recognised that companies could set different bonuses for different classes of policyholders, but had not accepted the practice of paying different bonuses within the same class on the

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basis of which option was exercised. Though Equitable would need to revise their bonus policy for future years, the new approach need not lead to any significant additional costs for them; they could, potentially, nullify the benefit of the guarantee by reducing bonuses for all policyholders with GAR options. While the question of compensation to policyholders whose policies had matured in the previous five years could be assessed only after the House of Lords had given judgment, the prudential division considered it unlikely that such costs would impact significantly on Equitable's financial position. The reputational damage would only become evident at a later date.

31/01/00
FSA's legal division circulated a summary of the judgment to the prudential division and to GAD. They said that each of the four judges who had at that stage considered the case had arrived at their respective conclusions for different reasons. The outcome of the appeal to the House of Lords would depend to a significant extent on the panel selected to hear the appeal, and it was likely that they too would differ in the reasons for their decision. It was therefore not possible to predict that decision, and any attempt to do so, or to determine the implications of the Court of Appeal's judgment, would be of little benefit. They said that the Court of Appeal had not dealt with the issue of how Equitable were to comply with the judgment; if the judgment were upheld the means of compliance could significantly affect any implications for the industry.

The prudential division's memorandum of 28/01/00, setting out the implications of the judgment, was circulated to senior Treasury and FSA officials. It concluded that, while Equitable would need to revise its bonus policy for future years, potentially the new approach need not lead to any significant additional costs for the company.

01/02/00
Equitable wrote to policyholders assuring them that the Society remained, and would continue to remain, financially secure. They said that there would be no significant costs for them were the House of Lords to uphold the Court of Appeal's decision. [The prudential division were given a copy of that letter by a FSA employee who was also an Equitable policyholder, but they did not pass it to the conduct of business division. The conduct of business division, however, obtained a copy of the letter by another route.]

03/02/00
FSA told the Tripartite Standing Committee that there were no immediate concerns resulting from the Appeal Court ruling against Equitable's differential terminal bonus policy. Indeed Equitable's short-term accounting position would actually be stronger if they received less new business. In addition, the position was still not final as there was a strong possibility that the House of Lords would overrule the Appeal Court's decision. Equitable was still a strong brand and therefore likely to be taken over rather than fail. However, failure would have implications for the industry's financial stability and so the position needed to be monitored closely. The Committee noted, however, that Equitable's image had been badly damaged by the court ruling as there had been a public misperception that Equitable had failed to deliver the GARs, whereas it was the bonus payments which had fallen short of expectation.

04/02/00
FSA's prudential division wrote to all companies who had indicated in reply to the 1998 GAD survey that they had written with-profit policies containing GARs, asking how they determined bonus levels for such policies.

08/02/00
The prudential division requested from the enforcement team further information about the investigation into Equitable's sales of pension fund withdrawal schemes; that request was copied to the conduct of business division. The conduct of business division replied that the enforcement team had not found too many problems and that a discipline case was therefore unlikely.

17/02/00
The FSA's relevant managing director updated the Board on the outcome of Equitable's case in the Court of Appeal. He said that implementation of the judgment had been suspended pending the outcome of the appeal to the House of Lords. Meantime, Equitable did not appear to face any immediate financial risk or any additional threat to their independence. If the appeal judgment was upheld, Equitable would need to revise their bonus policy, but potentially the new approach need not lead to significant additional costs. For now, the moderate reduction in new business that the company had been experiencing would actually help to strengthen their finances. The FSA would be writing to other companies adopting similar bonus practices to explore the implications if the judgment were upheld.

01/03/00
A bilateral meeting of the prudential and conduct of business divisions of FSA did not refer to Equitable.

02/03/00
Prompted by responses to the prudential division's letter of 04/02/00, which showed that only a small number of companies were imposing the costs of guarantees only on those policyholders with GAR options, FSA's legal division queried whether it could be argued that such a practice would breach policyholders' reasonable expectations and be contrary to the Court of Appeal ruling. The prudential division replied that they did not think so. They explained that insurers had always declared bonuses by class [of policy], and said that if higher expenses attached to a particular class, they would consider it reasonable to declare a lower level of bonus for that class. They pointed out that the Master of the Rolls had said in his judgment that, if Equitable could not declare a differential rate of bonus, it was possible that they would declare a lower, unified rate. GAD contributed to the discussion, saying that they had little difficulty in concluding that policyholders'

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reasonable expectations, as defined by three of the four judges who had so far considered the matter, had **not** been breached by Equitable or by any other company, except to the extent that a breach of contract was of itself a breach of those expectations. They said that asset share and other accepted means of determining terminal bonuses would all require some form of deduction for GAR options; alternatively, any loss to a company arising from such guarantees would usually be allocated to the class which caused it. The legal division commented that the Insurance Companies Act required that FSA undertake their own analysis and that the Court's view was only one factor to be taken into consideration.

09/03/00
The prudential division circulated a note of a meeting that they had had the previous day with the enforcement team about Equitable's sales of income draw down pension products. The note said that the enforcement team had "*left to one side*" the question of how Equitable had advised GAR policyholders, as the issue remained uncertain in the light of the ongoing court action. The prudential division said that the income draw down investigation did not look too good for Equitable, but was not disastrous from a regulatory solvency point of view.

22/03/00
Equitable published their statutory annual report and accounts for 1999 and declared a bonus of 5%, the same as for 1998, considering that no further decrease in bonus was appropriate. The accounts stated that £200m - as for 1998 - had been included as prudent provision for any additional liabilities which might arise through clients choosing to exercise GAR options under their policies. Their directors' report and accounts made no specific mention of the legal action or of any other contingent liabilities. The Annual Report did however set out the background to the litigation and said that the House of Lords' decision hearing was the next stage.

23/03/00
The fifth quarterly meeting took place between the Treasury and FSA's prudential division. (Equitable was not discussed.)

16/04/00
FSA's Board met. (They did not discuss any matters relating specifically to Equitable.)

15/05/00
In a letter to the appointed actuaries of all life insurance companies, the Government Actuary said that, in the light of amendments that the Treasury had made to the 1994 Regulations, two of the three scenarios promulgated in earlier guidance on resilience testing now appeared unnecessarily severe. He had therefore discussed with FSA revisions to the test which both FSA and GAD considered appropriate. The revisions, which he went on to set out in detail, would apply from the date of coming into force of the amendments to the regulations.

23/05/00
In an internal memo, the prudential division said that the enforcement team had sent Equitable a report of the investigation into sales of their pension fund withdrawal schemes. Once Equitable's response had been received and considered, the matter would go before the Enforcement Committee who, unless Equitable were able to present a credible challenge to the report's findings, were expected to call for a fine and remedial action, including compensation for investors. The level of any fine, and the cost of any compensation, would depend upon the report's conclusions, which could be finalised only in the light of Equitable's response. The prudential division commented that, given Equitable's relatively precarious financial position, they would need to assess the financial implications ahead of any decision.

25/05/00
A conduct of business official visited Equitable in preparation for their series of inspection visits in June. Prudential officers did not attend the meeting and the record of it was not copied to them. Equitable were advised by conduct of business that GAR issues were not on the agenda as they were subject to a ruling in the House of Lords. Equitable said that the only company wide issue for them at the moment was the GAR situation. Outside sources estimated that if Equitable lost it would cost them £1bn, although Equitable estimated it would be more like £50m. Equitable said that business levels had levelled off recently due to the GAR publicity. Complaints, normally around 300 per annum, had increased recently due to GARs. Equitable said they had only a few "*carpet-baggers*" and were "*not a particularly good bag*" due to their low free assets, lack of estate and low expense ratio.

29/05/00
The Insurance Companies (Amendment) Regulations 2000 (amending the rules for determining a life insurance company's liabilities) came into effect.

31/05/00
Equitable's then solicitors provided the prudential division with copies of the Agreed Statement of Facts and Issues and the document setting out Equitable's case for the House of Lords' hearing. They said that they had written to solicitors for Mr Hyman seeking consent also to provide a copy of his case, but had received no reply. The prudential division circulated those documents to GAD and legal division.

02/06/00
The prudential division told the legal division and GAD that they did not propose to approach Mr Hyman's solicitors direct for a copy of his case, as the reasons that they would have to give might suggest that they would or could act, depending on the outcome of the hearing. They said that they would not want to generate such an expectation and saw no problem in waiting until the hearing began, when the documents would become public.

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05/06/00
The prudential division obtained copies of Equitable's court papers and told GAD that on the basis of a quick scan there did not look to be anything particularly new in them. GAD replied that the Lords' judgment on the application to business decisions about bonus rates of the concept of policyholders' reasonable expectations would be of considerable interest to FSA and to other insurers.

07/06/00
The sixth quarterly meeting took place between the Treasury and FSA's prudential division. Equitable was not discussed.

12/06/00
The House of Lords' hearing began.

12-28/06/00
The PIA carried out a (conduct of business) supervision visit to Equitable.

15/06/00
FSA's Board met. (There was no reference to the Equitable case.)

19/06/00
A bilateral meeting of the prudential and conduct of business divisions was held. (It did not refer to Equitable.)

27/06/00
Equitable applied for a section 68 order for a future profits implicit item of £1.1bn for use in their year 2000 regulatory returns.

30/06/00
Equitable submitted to FSA's prudential division their regulatory returns for the year ended 31/12/99.

04/07/00
FSA's managing director told the chairman, and the prudential division's senior managers, that the then senior independent director on the Equitable Board had contacted him saying that while Equitable had no firm idea of the likely judgment, there were "*straws in the wind*" that the Lords would find against Equitable. The Equitable Board were therefore giving some thought to what ought to be done in the event of an adverse decision. The main concern for Equitable appeared to be "*what level of sacrifice*" might be needed at the top of the organisation. Their chairman and the chief executive both wished to resign in that circumstance. The Equitable director was worried that that might be unnecessary unless the judgment criticised the way Equitable had operated, and felt that it was vital for their executive to remain at full strength to handle whatever transition was necessary. FSA's managing director had made a note saying that in his view FSA should place considerable emphasis on retaining an adequate executive relationship, and that the presence or absence of detailed criticism in the judgment would be crucial to how senior figures might wish to respond.

05/07/00
Having consulted FSA's chairman and the insurance director, the managing director telephoned the Equitable director. He said that the FSA were anxious to ensure continuity among executives and that any resignations might be phased to permit continuity. It would depend on the material in the judgment but on what FSA knew so far "*it was unlikely that they would be throwing brickbats at Equitable*". An undated note in the papers told FSA's insurance director that the head of the prudential division had seen the managing director's note and agreed with what he had said.

07/07/00
GAD recommended that the prudential division support the section 68 order Equitable had applied for on 27/06/00. GAD noted that, although the information provided in the application was a little sparse in places, based on that information there was a significant margin between the amount that Equitable had applied for and the maximum that they could have applied for - which was £3.3bn. GAD said that the appointed actuary had confirmed that he had taken account of the effect of the reinsurance treaty in determining the value of future profits.

12/07/00
FSA's Executive Committee met and were told that the House of Lords' judgment was expected soon.

18/07/00
Equitable met with FSA's prudential and legal divisions and GAD to discuss contingency planning for the House of Lords' judgment, which was due to be given on 20/07/00. The official record of the meeting by the prudential division said that while it was thought unlikely that the House of Lords would find against Equitable, they discussed the possibility that Equitable might be prevented from altering the rate of bonus for policies containing GAR options, so that they would have to give an annuity at the guaranteed rate on unadjusted asset share. A contemporary manuscript note by a GAD officer attending the meeting recorded the opposite conclusion, i.e. that the actual outcome **was** the "*Most likely outcome*". [FSA cannot now explain how the GAD and prudential divisional representatives left the meeting with opposite understandings of what Equitable had been saying to them on this matter.] It was noted that that had not previously been seen as a probable outcome, but had become so following arguments put forward at the House of Lords' hearing. It was also noted that such a ruling (referred to as the third option) would have a profound effect on Equitable's solvency. It was estimated that the cost of paying such additional benefits would be in the region of £1bn to £1.5bn. Equitable had not attempted to renegotiate the reinsurance agreement - which would be invalidated if judgment was given against them - to take account of such a ruling, and the appointed actuary considered that such renegotiation was unlikely to be viable. Equitable would have to fund the additional bonuses from their own resources. In the event of such a ruling, they would immediately announce their intention to seek a partner as it would not be in the best interests of

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policyholders for Equitable to continue in a weakened financial state, particularly if the investment policy had to be changed to a more conservative one. Though Equitable did not believe that they would then be insolvent [in other words they believed that they would still meet the required minimum margin], they were keen to avoid precipitous regulatory action should the judgment go against them, mainly because that could have a detrimental effect on the value of the business. The prudential division said that they understood the importance of maintaining the value of the Society and would not rush to take remedial action in such circumstances, though they would need to be convinced that a suitable buyer was likely to be found quickly. Equitable considered that substantive sales negotiations could begin with a number of potential partners in August, with a view to completing a sale before the end of the year. If the House of Lords simply upheld the Court of Appeal judgment, Equitable expected to reduce the bonuses payable to GAR policyholders as a class; they did not consider that that would contravene the judgment, although that could lead to arguments that they had ignored the spirit of the House of Lords' judgment.

The prudential division told a meeting of FSA's Executive Committee that the House of Lords' judgment was expected on 20/07/00.

19/07/00
Following the previous day's discussion, the prudential division prepared a note setting out the possible outcomes of the House of Lords' appeal, and the regulatory action that was likely to be appropriate in each case. The note recognised the third option as a possibility which, the author said, "*is not something that has been considered previously*", but said that it was much less likely than the other two potential outcomes. [FSA say that, according to the author of the note, this reference must be to the court not to the prudential division; as clearly both Equitable and FSA had previously considered it in their scenario planning. FSA's previous scenario planning had mentioned the possibility of Equitable losing the court case badly and Equitable having possibly to consider reducing bonuses for all policyholders, but it had not specifically considered the possibility of the court opining on the apportionment of bonus between the GAR and non-GAR policyholders.] The note said that should the third option become reality, Equitable would only just be able to meet their regulatory solvency margin, with assets of £3.8bn at the end of 1999 to cover a solvency margin of £1.1bn. Though Equitable could adjust their investments to match assets and liabilities more closely, that would result in a reduction in returns to policyholders and a probable loss of market confidence in the company. The company had therefore decided that, in such circumstances, they would seek a partner; it was expected that there would be no shortage of potential partners. (As this information was sensitive it was given only a very limited circulation within FSA, including the chairman and managing director. It was not passed to the conduct of business division.)

20/07/00
The House of Lords' judgment confirmed that Equitable could not apply different rates of bonus depending on whether or not the policyholder took benefits based on GARs. It also ruled out the possibility of paying lower bonuses to GAR policyholders as a class [ring-fencing].

Equitable's Board were told that the consequential additional liabilities to Equitable, as a result of the House of Lords' decision, had risen from the previously estimated £50m to £1.5bn.

Equitable immediately announced that they were seeking a buyer.

Equitable told FSA's prudential division that they planned an immediate cut of 5% in the value of all with-profits policies on non-contractual termination; no bonus would be allotted for the first seven months of 2000; they said that they expected bonus levels to be restored once a sale had been completed.

GAD advised the prudential division to write to all with-profit insurers, not only those with GAR policies, as the implications of the ring-fencing judgment could go beyond GAR matters.

The prudential division circulated to the conduct of business and legal divisions, GAD and the Treasury, a document setting out the line they intended to take with the press. That said that they were aware of the contents of the judgment and Equitable's response to it; that there may be implications for other companies; and that they would be asking companies for their assessments of the implications, so that FSA could then consider any regulatory implications.

FSA's Board were told of the House of Lords' judgment, and of Equitable's decision to seek a buyer.

From this date Equitable required their sales force to ensure that all new business proposers signed a declaration saying: "*I acknowledge and agree that should there be a transfer of the Society's business to a third party or should the Society demutualise during the period of two years from today's date I shall not be entitled to any benefits resulting from such transfer or demutualisation in respect of the policy for which I am now proposing*".

21/07/00
In a note to FSA's prudential division, the Treasury said that they thought it likely that they (Treasury) would be asked for a brief on the situation with Equitable. They said that the judgment prompted thoughts on the wider implications for the future development of the life sector, and the effectiveness of the regulator, which were the sort of topics that they would discuss at quarterly meetings. They set out a number of questions concerned with the implications for the industry as a whole, including: whether FSA ought to have done more; whether

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the guidance on reserving had favoured companies over policyholders; and whether the judgment had changed the regulator's understanding of policyholders' reasonable expectations. The Treasury said that, while they did not want answers at that stage, the prudential division should consider those points and be ready to respond at short notice should that become necessary.

FSA's legal division produced a summary of the judgment, which concluded that the wider implications for other companies with GAR options were unclear; accordingly, while the guidance letter issued by Treasury's insurance division on 18/12/98 would need to be amended in the light of the judgment, and would need to be less positive in its tone, it was not clear at that stage whether substantial amendment would be necessary.

23/07/00
Equitable sent their sales representatives a "*first-aid*" briefing pack to assist them in dealing with queries from policyholders and prospective policyholders about the House of Lords' judgment and its implications. The pack said that final bonuses had been suspended until the Board met the next week to consider revised rates. The sales force would be briefed then on the implications for new and renewal business. Meantime, new with-profits business could continue to be written on the basis that it could be "*cooled off in the unlikely event that investors find the revised terms unattractive*". As it stood, the judgment would affect the statutory reserving position which could lead to constraints on investment freedom in the future. However, selling the business would avoid such constraints and "*hence the prospects for future investment returns are undiminished*". If asked what would happen if no buyer were to be found, the response suggested was that, as recent press articles had indicated, this was unlikely to happen. "*It is therefore perhaps unhelpful to speculate on such a hypothetical situation at this stage.*" A note on meeting with prospective clients set out the standard structure to be followed, which made no mention of the House of Lords' judgment. A concluding note, however, said "*Clearly if the GAR issue and demutualisation are raised by the client the representative must cover all the points raised in … the meeting structure for existing clients*". All prospective policyholders were to be asked to sign a declaration as to their understanding of their position if Equitable's business were transferred or the company were to demutualise. The note said that the press had taken a broadly consistent line in relation to Equitable's position including that there would be no shortage of potential buyers, with price estimates ranging from £2bn - £6bn; using £4bn as an example the potential average windfall for policyholders would be £2000. However the ruling had led to a reassessment of Equitable's credit rating. [As this was an internal Equitable briefing, FSA did not have access to it.]

24/07/00
FSA reported to the Tripartite Standing Committee the consequences of the House of Lords' ruling against Equitable. They said that there would only be real problems if Equitable could not find a buyer by the end of the year. Currently, however, that problem did not seem at all likely to emerge. The GAR point arose for 20-25 other firms, but FSA had already made most of them reserve sufficient amounts to cover the costs. There might however be some others coming on the market as well as Equitable.

FSA's prudential division told GAD that, in their view, the House of Lords' judgment had no implications for the life insurance industry as a whole. The impact of the judgment on Equitable had resulted from a reduction in assets, as it had rendered void the reinsurance treaty, rather than from an increase in liabilities; that was unlikely to be the case for other companies. They had required companies to reserve fully for GAR options with the same level of reserve being required whether or not differential terminal bonuses were paid. All that had changed was that ring-fencing had been ruled out, which meant that terminal bonuses would increase in the short term, though they could then be reduced; since companies were not required to reserve for terminal bonuses, there would be no need to increase statutory reserves. GAD replied, confirming the prudential division's analysis. They said that, in retrospect, Equitable had acted imprudently in taking credit for the reinsurance and that they had done so probably in the belief, based on the legal advice they had been given, that they would not have to change their bonus policy.

The prudential division provided a briefing on the implications of the judgment to FSA's policy and standards division, who were concerned that it could impact upon a review they were conducting into the mis-selling of personal pensions. The prudential division said that while a sale could not be regarded as an absolute certainty, it had to be close to 99.9%. Equitable saw a sale as the only option, and it was unlikely that they would fail to find a suitable buyer. They said that the provision that Equitable would have to make for pension mis-selling was likely to increase, though the amount of that increase was unlikely to be significant in the context of the other reserving cost measures the company would experience, which could amount to £2bn.

An action plan was circulated within the prudential division, and to GAD and the legal division, under which FSA were to obtain confirmation as to Equitable's solvency and review projections of future solvency; review the 1998 guidance; ask other companies what implications they saw for themselves; and arrange discussions with Equitable about the sale process. [The plan was not copied to the conduct of business division, although it was copied to the chairman and to the managing director.]

26/07/00
FSA's Executive Committee discussed issues surrounding Equitable's position.

Equitable announced changes to bonus rates. With-profits policies would be credited with no growth for the first seven months of the year, but the previous growth rate would apply from 31/07/00. They said that in selecting a

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buyer, they would be aiming to maximise the value obtained for the benefit of all members and in particular to secure funds to make up the lost growth.

Equitable's appointed actuary wrote to the prudential division setting out the company's solvency position. He said that the revised resilience test 2 had been intended as a relaxation of the reserving standards, but that in Equitable's current circumstances it was in fact more onerous than the former test. He believed the former test [i.e. that applicable prior to the revision of 15/05/00] to provide an adequate margin of resilience as required by regulations. Using the former test, the company had free assets of £225m, after allowing £150m for increased benefits for GAR holders who had already retired. The take-up rate for GAR options had been assumed such that gross reserves for those policies were reduced by less than 5%, in line with GAD guidance. He pointed out that the reinsurance treaty remained in force until three months after the House of Lords' judgment, and that Equitable were discussing the possibility of an amended treaty which would give the same reserving effect. While accepting that the company's position would be unacceptably weak on a continuing basis, he suggested that, in view of the steps that they had taken to strengthen the position, Equitable should be regarded as meeting the required minimum margin.

FSA's prudential division prepared a briefing note for the Treasury in response to the questions the Treasury had raised in their memo of 21/07/00. They said that the guidance given to the industry broadly required companies to assume that virtually all policyholders would exercise their GAR option if it would be to their advantage. In practice many policyholders would not fully exercise the GAR option, because it provided a form of annuity that was unattractive to them. That meant that, although the judgment was likely to result in an increase in the real costs arising from GAR options (as it was likely that the take-up and cost of those options would increase), the reserving costs were likely to remain unchanged, because companies had already had to assume that virtually all policyholders entitled to a GAR would opt for it. The increased cost of meeting those guarantees would therefore arise from companies paying a higher level of terminal bonus, for which they did not have to reserve. Equitable appeared to be unique in the difficulties it was now facing. On the matter of whether the regulator had "*got it right*", they thought that "*On balance, we did not do badly and indeed it would have been difficult for any guidance to be consistent with the full range of judgments that have appeared*". The guidance on meeting the cost of GARs would have to be reviewed but it was not clear that it had been "*wrong*". The emphasis needed to be changed, so as not to appear to suggest that most policies and policyholders' reasonable expectations would allow differential terminal bonuses. However, if the prudential division had been wrong, so too had the actuarial profession, since the Faculty and Institute of Actuaries had gone on record as saying that they fully supported the guidance. The prudential division were not convinced that either the Treasury or FSA could or should have pushed Equitable to alter their bonus practice; that practice "*was not clearly unlawful*", as had been demonstrated by the first judgment and the fact that the Court of Appeal had found against them only by a majority. On the question of policyholders' reasonable expectations the judgment gave some helpful pointers, but also clouded the issue of whether bonuses had to be consistent with those expectations, or whether they were just one of a number of factors to be considered. Overall, they were probably not much further forward in understanding or defining the concept.

27/07/00
FSA's prudential division wrote to with-profits companies seeking their assessment of the implications of the judgment on their businesses.

The legal division circulated some suggestions about how FSA might revise the guidance to the industry. They commented that the previous guidance had given the impression of allowing a wide range of practices, albeit subject to particular circumstances and contract terms; the revised note would need to avoid appearing to justify existing practices and should make clear that any charge for guarantees should be explicit and specific. The prudential division agreed with the legal division's view.

The prudential division agreed that, rather than waste time and credibility in justifying the earlier guidance (which they nevertheless considered to be justifiable), they should take the House of Lords' judgment as an opportunity to issue a new guidance note.

31/07/00
Another life company told the prudential division that the consequences of the Lords' judgment for them were "*pretty dire*" particularly if the judgment was construed widely. They arranged to meet with FSA to discuss the position.

02/08/00
Equitable wrote to all their policyholders explaining the impact of the House of Lords' ruling. On the loss of seven months bonus, they said that it was intended that that loss would be made good from the proceeds of the sale of the business. They said that, while after the Court of Appeal judgment they had told policyholders that there would be no significant costs imposed on Equitable if the Lords upheld it, in the event the Lords' ruling had gone substantially further and for that reason its impact had been far greater. The ruling had increased Equitable's required statutory reserves, diminishing capital strength and reducing investment freedom. The letter concluded that Equitable remained an excellent business and members would continue to benefit from its many underlying strengths. [The conduct of business regulators obtained a copy of this letter from a policyholder, which they placed on their file.]

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04/08/00
Equitable's appointed actuary sent the prudential division copies of their previous correspondence about resilience test 2, and cited some recent figures to demonstrate that the new test was more stringent than the previous test in its impact on Equitable. He also said that discussions with the reinsurer were proceeding for an amended version of the reassurance arrangement and he would give further information at a meeting to be held a week later.

In a further letter the same day, he told the prudential division that Equitable's excess assets at the end of the year were expected to be £200m, if they wrote no new business, and £210m otherwise.

08/08/00
The prudential division asked FSA's enforcement team for an update on two enforcement cases outstanding against Equitable.

11/08/00
At FSA's request, Equitable and their advisers met the prudential division and GAD to discuss the regulatory aspects of the sale process. Equitable said that they intended to provide sales information to interested parties by the end of August and hoped to have identified a buyer by December; they aimed then to complete the sale by June 2001. FSA considered that to be very optimistic, and pointed out that obtaining agreement for a sale would not be straightforward. The prudential division said that they would want to ensure that policyholders' interests were protected and that, while they would give priority to the regulatory aspects of the sale, they had limited resources and might not be able to consider proposals as quickly as Equitable would want them to. Equitable said that compensation would be due to policyholders and they estimated the cost at £150m; the appointed actuary said that, at worst, it could amount to £350m. Equitable had negotiated a new reinsurance agreement to provide cover when more than 60% of policyholders opted for the GAR; even after taking account of that, however, they had explicit assets of only £1.58bn to cover a required minimum margin of £1.19bn. That figure had been arrived at using the old resilience test 2, and Equitable said that application of the new test would be likely to reduce the Society's free assets by £600m; they agreed to provide FSA with monthly solvency reports.

14/08/00
Equitable met a group of policyholders and according to members' notes of the meeting, told them that, while Equitable met the solvency rules, with its present range of assets Equitable could not pass the [second] new resilience test. The members were also briefed on the alternative courses of action that had been considered by Equitable's directors. [It would appear that the regulators were not aware of this meeting at the time. The copy of the notes held in FSA's conduct of business division files had been sourced from the internet and was dated 08/10/00.]

[Equitable subsequently told my staff through their solicitors that, if such a meeting took place, none of the relevant Equitable officers were still with the Society. The current appointed actuary had confirmed that it seemed unlikely that such officers would have made such a statement and indeed, current officers had no reason to believe that Equitable would not then have been able to meet the new resilience test 2 in the form in which it had been published.]

23/08/00
An internal note from FSA's prudential division warned supervisors that a number of companies were currently being restructured in ways involving exercise of due diligence by a prospective new controller. Companies would need to consider whether the Lords' judgment was likely to have a significant effect on the due diligence already performed and the financial position of any of the companies involved.

FSA's Executive Committee met. There was some discussion of the Equitable case, and the prudential division said that they were preparing a paper for consultation on the impact of the judgment.

24/08/00
The House of Lords' judgment and its implications were discussed at the eighth bilateral meeting between prudential and conduct of business divisions. The prudential division said that the judgment would have implications both for Equitable and more widely among the insurance industry. They said that it was hoped that a buyer would be identified by December, and that the process of demutualisation should be completed by June 2001, although whether this was achievable would depend on a number of factors; in the meantime, Equitable were just covering their solvency margin. The judgment was not considered to have solvency implications, as the level of reserving had not been affected, although it was noted that some companies would experience higher real costs. Equitable had experienced a weakening of their financial position only because the reinsurance had been conditional upon their continuing to pay differential terminal bonuses, and so had been terminated following the judgment. The reinsurance treaty had been renegotiated, which had given the company "*a bit more breathing space*"; however, the solvency position "*remained tight*". [According to the Baird Report, as a result of that meeting, FSA's conduct of business division concluded that Equitable remained solvent and need not therefore be required to make specific disclosures to new policyholders.]

25/08/00
Equitable's advisers sent to companies who had expressed interest in acquiring Equitable an information memorandum to assist them in their preliminary assessment, along with information on the related sale process.

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01/09/00
FSA's prudential division prepared a paper recommending that the Insurance Supervisory Committee should grant Equitable's application [of 27/06/00] for a section 68 order permitting a future profits implicit item of £1.1bn. The paper said that, despite losing in the House of Lords, Equitable were still solvent, but they had been weakened to the extent that they were seeking a buyer. The prudential division had routinely granted such concessions, provided that they had been satisfied that the calculation provided for in the regulations (which, they said, provided a conservative estimate of future profits arising from business already written) had been correctly carried out. By that calculation, Equitable would be entitled to an implicit item of £3.3bn, but were seeking only a third of that, and were unlikely to depend on the implicit item to cover the required minimum margin. Equitable's excess assets at the end of June 2000, "*re-stated post judgment*", amounted to £1.39bn. Equitable's profits were expected to improve by the end of the year. Detailed calculations provided by Equitable had been reviewed and approved by GAD, who were fully aware of the context in which the concession would be granted. While a number of uncertainties could affect Equitable's balance sheet, those should not significantly affect the future profits implicit item calculation.

Equitable's appointed actuary wrote to the prudential division with a monthly solvency update to 31/07/00 showing excess assets of £1.3bn. He enclosed copies of the signed addendum to the reinsurance agreement and provided information about Equitable's investments which GAD had asked for at the meeting on 11/08/00.

The prudential division asked the enforcement team for a response to their enquiry of 08/08/00. The enforcement team replied that work on one case - the pensions review - was unlikely to begin for several weeks owing to other priorities. They had received Equitable's initial response to their findings in the second case - pension fund withdrawals - and were expecting a further response by 07/09/00; they said that the initial response had not been extensive but had contested some of their findings.

05/09/00
The prudential division circulated a draft paper, to be issued to members of the FSA Chairman's Committee, setting out the background to, and objectives for, issuing a consultation paper on draft guidance to the industry on the FSA's approach to interpreting the implications of the Lords' judgment.

07/09/00
Treasury officials told the then Economic Secretary that FSA wanted, by the end of September, to issue a consultation draft of new guidance to those companies that had sold GAR products about the implications of the House of Lords' judgment and what, in the light of that judgment, FSA now understood to be policyholders' reasonable expectations.

08/09/00
The conduct of business division gave the prudential division some immediate reactions to their draft guidance for the industry. They said that they were unable in the short time available to provide a considered response to all of the points.

11/09/00
The chairman of the Insurance Supervisory Committee told members, by e-mail, that Equitable's section 68 application involved a "*fairly standard request*" for a concession for a future profits implicit item. He said that the prudential division's paper (of 01/09/00) made clear that Equitable's request was well within normal parameters, and he saw no difficulty in agreeing to the recommendation. He added, however, that the implicit item was an important aspect of Equitable's overall financial position and, given the company's high profile at the time, some members might wish to discuss the paper. He asked members to let him know by noon that day if they wanted to discuss the application. One member of the Committee replied pointing out that the amount of future profits that Equitable could take into account in their December 2000 return could not exceed the amount that could be supported were a new section 68 application to be made at that time. Equitable were expected to show a sharp fall in surplus for 2000 because of the judgment, and so in practice if the application were granted, they might in any event be unable to use the full amount in their returns. However, that was not a reason to refuse the application. The Committee approved the application the same day without meeting.

12/09/00
The prudential division told the FSA managing director that there were strong regulatory reasons for putting out some early guidance to the industry on FSA's view of the implications of the Equitable judgment. They had been unable to clear a draft internally in time for it to be discussed at that day's Chairman's Committee, but they still hoped to seek Board approval in September.

The prudential division told Equitable that they had asked the Treasury to issue a section 68 order in respect of the future profits implicit item for which they had applied. They went on to point out that the amount of the implicit item actually shown in the annual return due on 31/12/00 could not exceed the amount that could be supported by a new application submitted with that return. They also said that, were Equitable to demutualise, the company taking over the business would not be able to take advantage of any surplus that had accrued in Equitable to generate an implicit item for itself.

13/09/00
The Treasury granted Equitable's request of 27/06/00 for a section 68 order for the lesser of £1.1bn or 50% of the full amount of future profits.

19/09/00
The inaugural meeting of FSA's Firms and Markets Committee noted a FSA decision on another life insurance matter. No reference was made to Equitable.

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20/09/00
The seventh quarterly meeting took place between the Treasury and FSA. The Treasury pointed out that Equitable were advertising for new business. FSA said that Equitable's difficulties did not affect their solvency, only their freedom to invest. It was noted that a number of other companies followed practices similar to that of Equitable; FSA said that they did not see that as a huge problem in the short term because the solvency of the companies would not be affected, although there was concern about the ramifications of the judgment on those companies. There was some discussion of FSA's proposal to issue guidance to the industry, and they undertook to keep the Treasury informed on what they were doing in that regard.

21/09/00
At a meeting of FSA's Board, the relevant managing director reported that the House of Lords' ruling went further than simply saying that Equitable could not adjust terminal bonuses for those who opted for a GAR so as to reduce the value of the guarantee. It had also said that Equitable could not ring-fence GAR business from other with-profits business for the purpose of setting the terminal bonus. The extra costs of the GARs therefore had to be spread amongst all policyholders in the fund. This had potentially serious implications for the reasonable expectations of other with-profits policyholders. Reports to FSA from the industry indicated that there was considerable confusion and uncertainty as to how they should respond. Work was therefore in hand to prepare guidance for the industry. The Board was content that the guidance be published in advance of the next meeting, provided that the executive directors were satisfied with its adequacy.

Equitable sent their sales representatives further guidance on advice and sales issues arising as a result of the House of Lords' ruling. If clients asked whether Equitable was secure, the representatives were advised that the following simple statement might suffice to meet concerns that Equitable might be unable to meet a claim: "*All UK insurance companies are subject to strict supervision by the regulatory authorities. They would not allow any company to continue accepting new business if they were not satisfied that it could meet its liabilities*". New members were to be told that the sale of Equitable would provide funding sufficient both to restore policy values and preserve the investment freedom of the with-profits fund for the future. Along with existing members, all new members were likely to benefit in general terms from the sale, for example, from the greater investment freedom a sale would bring. [Again, as this was an internal briefing it was not made available to the FSA.]

22/09/00
GAD told the prudential division that they had reviewed copies of the addenda to the reinsurance agreement and considered it satisfactory. They went on to say that, without the future profits implicit item, Equitable would have excess assets of just £300m, and that the resilience reserve, which they took to be calculated on the old basis, was substantial at £1.8bn. However, they had no questions to raise on the figures provided at that time.

04/10/00
A note of a FSA Firms and Markets Committee meeting said that another company had alerted the Treasury to their potential difficulties in relation to GARs.

FSA's public enquiries unit, acting on advice from the prudential division, sent the conduct of business division a copy of a letter addressed to Equitable, which had been copied to FSA, in which the writer was complaining about the nature of Equitable's advertising in the light of their current situation. The conduct of business division were asked to comment on whether Equitable's advertisements were misleading. They replied that, while they could see why the statements made would cause considerable annoyance to Equitable policyholders, nevertheless the GAR issue should not overshadow Equitable's many other business activities. They said that Equitable had achieved a record of success and had a good reputation; while the division had not seen the advertisement in question, it appeared that the claims were based on the past rather than the current position. Overall the conduct of business division did not think they could support the call for the advertisements to be withdrawn.

06/10/00
Following an approach by one of the bidders for Equitable (bidder A), the Office of Fair Trading asked FSA's prudential division if they had any thoughts or concerns about the potential merger.

The prudential division noted that Equitable had received "*three serious offers to buy the group*". Equitable's appointed actuary had told them that the bids were high enough to enable with-profit policyholders to gain restitution for the investment growth they had lost for the period 1 January to 31 July 2000 with additional goodwill on top.

09/10/00
The prudential division proposed a meeting with GAD and the conduct of business division to discuss their response to the request from the Office of Fair Trading and any wider issues arising from the proposal.

Equitable's appointed actuary provided the prudential division with an estimated solvency position as at 31/08/00 showing excess assets of £2.165bn. According to his covering minute, the huge change from the July position was due to the markets having strengthened in the interim, and he provided some analysis of the sensitivity of Equitable's solvency to equity and gilt yield movements. He also provided a copy of a letter sent to policyholders regarding the proposed compensation scheme.

In an internal e-mail, the prudential division commented that, whilst there was some comfort to be derived from

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the fact that there were some proposed bidders with reasonable offers on the table, it would have been better to see "*more big hitters in the frame*".

11/10/00
FSA's Firms and Markets Committee met. The Committee heard that Equitable had received three serious offers and that the appointed actuary believed that the bids were sufficiently high to enable restitution to policyholders for the loss of growth in the first part of 2000, together with an additional element for good will.

12/10/00
FSA told the Office of Fair Trading that the main issue for FSA, if the company concerned proceeded with the proposed acquisition, would be how the acquisition was financed.

The conduct of business division received a copy of a letter sent to the Advertising Standards Authority, which enclosed a copy of members' notes of the meeting that had taken place between representatives of a group of policyholders and Equitable on 14/08/00. The note said that Equitable had explained that regulations [i.e. the 1994 Regulations - paragraph 22] required Equitable to be "*reasonably certain*" of being able to meet their guaranteed liabilities, regardless of likely variations in the values of their investments. The note said that there were two tests; a simple solvency test to show that the current value of assets was at least equal to the total liabilities; and resilience testing, to show whether solvency would still be maintained if adverse conditions in the financial markets reduced the value of their assets. According to the note, Equitable had said that with their present range of assets, they could not pass the resilience test. They had told the members that with their presently high proportion of assets in equities, they required an injection of £3bn in new funds to remain resilient. Considering the action which might be taken, Equitable had said that doing nothing was not an option because, given the statutory rules on life companies relating to investment freedom, "*whilst the solvency criteria could be seen to be satisfied resilience could not*". They had told the members that the advice they had received indicated that selling the business would not only restore resilience to the balance sheet, but would enable them effectively to repay the bonuses withheld and to provide a small windfall payment. The correspondent said that, as the meeting had demonstrated that Equitable were at present unable to satisfy government requirements to enable them to carry on business as usual, current investors were being misled about the returns they might expect to receive. The correspondent asked the Authority to prevail upon Equitable to withdraw its current advertising campaign and complete no new business without full disclosure of the position to potential policyholders. [It is not clear what action, if any, conduct of business division took as a result of the letter and enclosures.]

17/10/00
Having reviewed Equitable's letter of 09/10/00, GAD sent a memorandum to the prudential division pointing out that, while solvency cover was adequate, if equities were to fall by 15% Equitable would be unable to meet the required minimum margin. They said that that corresponded to a fall in the FTSE 100 index to around 5,700 and, since the index had recently been around 6,200, close monitoring was required.

FSA's Firms and Markets Committee met. The relevant managing director told the Committee that many companies appeared to be concerned about the implications of the House of Lords' judgment. He said that life insurers were receiving confused legal advice and there was an expectation that FSA would produce guidance on the issue, though it was proving difficult to draft any helpful guidance. FSA's press office, however, were not receiving enquiries about that or about the proposed sale.

FSA's chairman, managing director, the director and other prudential division staff together with a FSA lawyer met to discuss Equitable. They noted the concerns of another company whose business seemed to be significantly affected by the judgment. The meeting agreed that FSA should aim to produce a best attempt at advice on what the judgment meant and how FSA interpreted it in relation to the regulator's responsibilities. A discussion would be held with those counsel who were known to be advising life companies.

19/10/00
The FSA managing director reported to the Board that, despite difficulties in assessing the level of liability arising from the House of Lords' judgment, Equitable had received three serious offers. The appointed actuary had indicated that the bids were sufficiently high to enable repayment to with-profits policyholders of the loss of growth for the period 01/01/00 to 31/07/00, with an additional payment for goodwill. FSA would need to see the detailed bids and structure to determine whether the with-profits funds were strong enough to secure the desired restoration of investment freedom going forward. He said that FSA were preparing draft guidance on the implications of the House of Lords' judgment; companies were considering the implications of the judgment and it was apparent that there was a considerable amount of uncertainty as to how they should respond. The proposed guidance would be aimed at encouraging a degree of consistency. The minutes noted that the managing director had said that the situation was however becoming more complex and the giving of guidance more difficult.

FSA's prudential division and GAD attended a meeting with a company that was proposing to buy Equitable, at which various aspects of the proposed bid were discussed. The company said that they hoped by early November to have a full proposal for financing their intended purchase, and would then discuss the matter further with FSA.

FSA's chairman wrote to the director of the prudential division about press reports that two bidders might be preparing to use "*free estate money*" to acquire Equitable and that FSA would need to approve it. He asked if that was a possibility.

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20/10/00
An officer of FSA's prudential division replied to the chairman, copied to the managing director and the director, saying that three named companies were still in the running to acquire Equitable. Any proposal would require FSA approval. At least two of the potential bidders could seek to use free estate to help finance their bids, but FSA would need to ensure that the interests of their own policyholders, as well as those of Equitable, were protected.

25/10/00
FSA's prudential division attended a meeting of the Office of Fair Trading merger panel to discuss one of the potential bids for Equitable.

FSA's Firms and Markets Committee met but did not refer to Equitable.

27/10/00
Equitable replied to a policyholder's complaint about a current advertisement. They pointed out that their past performance was a matter of record; that they remained solvent; and that the "*temporary*" loss of bonus was expected to be made good following a sale. They went on to say that, in negotiating the sale, they intended to ensure that the House of Lords' judgment would have no long-term adverse effect on policyholders' expectations. In conclusion, they expressed the view that the advertisement met the relevant FSA and Advertising Standards Authority rules. [According to the Baird report, FSA's conduct of business division were reassured that Equitable were reviewing the content of their advertisements in the context of PIA rules, and that Equitable considered them to be fully compliant.]

FSA's enforcement team outlined to the prudential division the findings of a review into Equitable's sales of pension fund withdrawal contracts. They said that they were minded to recommend disciplinary action against Equitable consisting of a public reprimand, a fine in the region of £500,000, and an order to conduct a review of past business. Such a review was likely to result in administrative costs of around £11m to Equitable, and redress which they estimated at £30m for policyholders.

30/10/00
Equitable's appointed actuary provided the prudential division with the solvency figures for the end of September, which showed excess assets as £1.14bn.

31/10/00
Bidder A assured FSA that they were not behind a rush of recent press reports which seemed to "*talk down*" Equitable's value, and they still saw the Equitable sales force as a very worthwhile acquisition. However, they believed that the shortfall in Equitable's funds was greater than Equitable themselves had estimated. The company expressed concern that the wording of Equitable's policies allowed GAR policyholders to increase their contributions to the fund, to which the guarantee would attach, thereby increasing the fund's liabilities to the detriment of other policyholders in the fund. They said that they were investigating whether and how that liability might be capped, but said that they were more pessimistic on the issue than were Equitable's directors. They were not yet convinced that they would wish to make a bid.

FSA's Firms and Markets Committee met. FSA's chairman expressed concern over press reports that there was little interest in purchasing Equitable. He saw a risk that FSA could be presented with a scenario where only one bidder remained, and the purchase depended on FSA accepting certain proposals as to funding of the purchase which he would regard as controversial. It was agreed that the prudential division would talk to the bidder in question about their proposals. While only three bidders remained, it was still thought likely that "*a good sale*" could be achieved.

FSA's conduct of business division sent the prudential division copies of correspondence with members of the public about whether, in view of the present uncertainty, the with-profit fund should be marketed. FSA's conduct of business division said this was "*way beyond PIA advertising rules*".

Equitable's regulatory solvency position was declared as excess assets of £1.08bn including a £1bn future profits implicit item.

01/11/00
The relevant director reported to the FSA chairman his conversation of the previous day with the chief executive of bidder A. The chairman, in a manuscript note dated 31/10/00, commented that this was a useful conversation but it did not "*lower his worry level about Equitable*" and that an early discussion on the matter was very much indicated.

02/11/00
In a confidential briefing note to the chairman, the director referred to the concerns raised by the discussion with bidder A. He said that Equitable's regulatory solvency cover was being monitored monthly but remained fragile. A stock market fall to a FTSE 100 level of about 5700 could lead to them breaching the regulatory solvency margin cover. If that happened FSA would need to consider the position carefully. However, a decision to stop Equitable writing new business would finish them off as a sellable enterprise because the sales force was of crucial importance. It was hard to see that that would be in the interests of **current** [FSA's emphasis] policyholders - but the position of those not already in would have to be considered carefully too. There were also some reserving issues which FSA still needed to "*bottom out*" with Equitable. These included the extent to which GAR policyholders could top-up further their policies. The exposure could be significant. It appeared that, for reasons of sensitivity, Equitable had not yet sought to close this option down, but they expected to do so at some point. FSA would have to explore this with Equitable, and the cost implications if they could not.

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GAD suggested to the prudential division that one possibility for dealing with the top-up issue would be that FSA might issue an order preventing Equitable from accepting more than a specified sum in incremental payments. GAD said that that would cap the liability arising from GAR options, and the regulator could then ensure that Equitable were fully reserved for that liability. (A manuscript comment on the note read "*grounds*" and "*challengeable by court?*".) GAD said that that would be less drastic than stopping Equitable from writing new business which, they suggested, would almost certainly end any chance of a sale. They suggested that Equitable might then seek court approval to limit the liability on policies containing GAR options on the grounds that the interests of policyholders without such options would otherwise be prejudiced.

(The prudential division subsequently learned that Equitable had already obtained legal advice to the effect that, while they could limit top-up payments in certain circumstances, their ability to do so was restricted. The FSA's legal advisers subsequently advised the prudential division in similar terms. Equitable considered that that was unlikely to be of any significant benefit.)

FSA's prudential division discussed with the Office of Fair Trading a request by bidder A for confidential guidance should they bid for Equitable. Officials there had said that it seemed likely that the bidder would be given "*favourable guidance*" as any bid looked unlikely to be referred on competition grounds. This did not, however, provide clearance for any subsequent bid.

03/11/00
A meeting took place between Equitable, FSA's prudential division and GAD. FSA's record of the meeting noted that: Equitable were close to finalising a compensation scheme for GAR policyholders whose policies had matured since 01/01/94; Equitable's auditors, having considered the question of GAR policyholders increasing their benefits, felt comfortable with Equitable's figures, and believed that explanations given as to the basis for reserving had provided some reassurance to bidders; the prudential division had requested a copy of the auditors' valuation report (of which they had been aware since 01/09/00); and finally, that Equitable's appointed actuary had said that he was not aware that any bidder had raised concerns about reserving issues.

A note of the meeting prepared by GAD said that the aggregate value of the recent cut in bonus rates amounted to £1.5bn and that was expected to be sufficient to cover the cost of paying GARs on full asset shares. That meant that new policyholders should not have to meet the cost of GARs, although they would be joining a very weak fund. Equitable had set up a provision of £550m (all but £200m of which was to be met from reinsurance) against liabilities arising from additional payments made into policies containing GAR options; they were to review that for their year 2000 regulatory returns. Equitable had estimated that that liability might, at worst, increase to around £500m, net of reinsurance. GAD noted that Equitable did not appear to believe that the issue was a serious concern for potential bidders. Equitable were currently applying a variant of the resilience test recommended by GAD. They could either present this publicly (which might give rise to some adverse comment) or seek a section 68 order (concerning valuation interest rates) which would allow them to apply the standard resilience tests. If no sale were to take place Equitable would almost certainly have to stop writing new business, and very probably have to rearrange their investments to a more defensive position to protect against liquidation in the event of a substantial fall in equity values. GAD said that they believed that Equitable were currently covering their minimum capital requirement, but had very little room for manoeuvre in the event of a modest fall in equity values. Equitable had told them that the aggregate value of the proposed compensation scheme for policyholders who had retired since 1994 was £200m.

In an internal e-mail the prudential division referred to complaints that they had received which alleged that Equitable's advertising was misleading. The prudential division took the view that Equitable remained solvent and therefore, as long as the division had neither the grounds nor the intention to stop them writing new business, there was no reason why Equitable should not continue to advertise. A draft reply to respond to complaints had been prepared on that basis. It said: "*As regulator, we do of course monitor the financial position of insurance companies carefully. However, we understand that Equitable continues to be solvent for Companies Act purposes and indeed continues to maintain the required margin of solvency over its liabilities as required under the Insurance Companies Act 1982. As the Equitable continues to be a going concern, complying with the relevant regulatory requirements, we do not share your view that it should be prevented from marketing its products, which could be damaging to the business. Nor do we believe that at a time when the statutory requirements continue to be met, and when there is a realistic chance of a successful sale of the business, that the newspaper advertisement inviting potential customers to request additional information from the company, is misleading.*"

In an e-mail, which circulated the draft reply and was copied to the conduct of business division, the prudential division said that to prevent Equitable from marketing their products could be damaging to the business and, as there was a realistic chance that Equitable would find a buyer, advertisements inviting potential customers to seek further information were not misleading. The conduct of business division said that they had received similar complaints and that they shared the prudential division's view that it would not be reasonable to stop Equitable advertising, adding that it would probably be illegal to do so, although "*If we believed it was in breach in some way of its prudential requirements, that could affect the position*".

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06/11/00
At a meeting with the prudential division and GAD, another potential bidder (bidder B) expressed concern that Equitable's current future profits implicit items might be withdrawn following a sale. They asked about FSA's attitude to financial reinsurance instruments and were told that FSA had some concerns about such arrangements where they took advantage of regulatory arbitrage (paragraph 29); bidder B said that Equitable's reinsurance agreement fell into that category; they were also concerned that the reinsurer had the right to terminate the arrangement if Equitable became insolvent. Bidder B asked why Equitable had been able to include in their resilience reserve a Zillmer adjustment (paragraph 30) which effectively added $^{1}/_{2}$% to the investment return. They expressed concern that, due to what was described as Equitable's precarious statutory [regulatory] solvency position, Equitable might "*go through a period of statutory insolvency*" before making a recovery. They asked whether, were that to be the case, any relaxing of the regulatory requirements would be possible. GAD told them that, while it was highly unlikely that FSA would permit any such relaxation, it might be possible to overcome the problem were Equitable to remain a mutual. Bidder B said that the GAR issue, along with Equitable's practice of allowing policyholders to take retirement benefits at any age between 50 and 75, had created a deficit that was potentially larger than could be met by any goodwill payment that they might offer. They were also concerned that, by including an illustration of terminal bonus in the annual statements provided to policyholders, Equitable might have created an expectation on the part of those policyholders. Bidder B discussed with GAD and the prudential division various means by which they might provide capital support for Equitable, were a sale to go ahead. The prudential division noted that bidder B had significant concerns about the risks they would be taking on were they to acquire Equitable.

In a briefing to the chairman for his appearance before the Treasury Select Committee [on 07/11/00], the director reiterated the points made on 02/11/00 about the shortfall in Equitable's funds possibly being greater than they themselves estimated. He added that Equitable could face significant exposure to GAR policyholders topping up their polices further. He noted that solvency was reported to FSA monthly and confirmed that Equitable continued to maintain their statutory margin of solvency although solvency cover remained fragile, and a fall in the FTSE 100 to about 5700 could lead to them breaching the regulatory solvency margin. However a decision to stop them writing new business would finish Equitable off as a sellable enterprise because the sales force was of crucial importance; this would not be in the interests of policyholders. The director added that it was discomforting to see full page spreads in The Times exhorting the benefits of Equitable and all the awards they had "*won*" whilst at the same time there was real uncertainty about their financial future. There had been complaints that some of the claims made were misleading. FSA's prudential division would probably need to look into these claims as both the Advertising Standards Authority and the FSA's conduct of business advertising team claimed that the nature of the complaints made by policyholders were beyond their regulatory remit. The director said that the FSA's current public line was that the company remained authorised to conduct business and was therefore entitled to market itself. If FSA received any complaint about advertisements misleading consumers they would investigate the complaint on its own merits.

07/11/00
In response to a query from the managing director about the possible impact of recent equity price changes, the director pointed out that the required solvency margin included the requirement to meet a resilience test. Even if Equitable were at 100% solvency cover, which would equate to a FTSE 100 level of about 5700, they would still be able to meet a further 25% fall in the markets before having to close to new business.

The director also told the managing director in a further exchange of e-mails that the Chairman's Committee would need to take their own view of the draft guidance and might wish to be courageous in what they decided. On resilience testing he said that an overnight drop of 35% in equity markets would be difficult and a steep but not overnight fall would create problems if insurers were under pressure to move rapidly out of equities and into gilts, of which there was already a shortage. Equitable would need to move in that direction ahead of most of the market which would help them, but they were a big enough player to have some influence on the gilt market on their own.

08/11/00
An internal prudential division minute said that they had learned from FSA's press office that Equitable had apparently decided not to continue with their advertising campaign. FSA were sticking to the press lines already given and when asked if FSA had intervened, had simply said that FSA did not discuss dealings between themselves and regulated firms.

09/11/00
The managing director told the Tripartite Standing Committee that FSA were seeking guidance from lawyers on whether they could issue guidance to insurers on limiting the damage to the industry that could be caused by the Lords' judgment on Equitable. Asked about the implications for other insurers, the managing director said these would depend on how narrowly the judgment could be interpreted.

Bidder B told FSA's chairman that, although they had been very interested in acquiring Equitable, they had reached the view that the financial position was considerably worse than they had first thought, and perhaps rather more doubtful than FSA had been led to believe. While they had not entirely ruled out any possibility of proceeding, they expected soon to tell Equitable that they did not wish to do so.

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10/11/00
FSA's Firms and Markets Committee met. There was some discussion about the draft guidance that FSA had produced on the Equitable judgment but no other specific reference to Equitable.

FSA's prudential division subsequently told their legal division, in an e-mail, that FSA's chairman had told the Committee that FSA should not consult informally with companies on the proposed guidance - as they had intended to do - since the guidance was capable of being market sensitive and limited informal consultation might therefore be improper. The next step would be to consider a draft internally and put it to the Chairman's Committee. The prudential division said that it was still their aim to put out the guidance for full public consultation by the end of the month.

13/11/00
FSA sought Counsel's advice on their proposed guidance.

A paper prepared by FSA's prudential division pointed out that, in respect of GAR options, reserving costs may differ substantially from the real costs. That was because FSA required companies to reserve on the assumption that virtually all policyholders would take the guarantee if that was higher than the current market rate, whereas in practice many would not do so. The paper went on to say that the Equitable case had added to concerns already raised about the opacity of with-profit policies, where typically up to 60% of the benefits were determined by the directors. Consideration was being given to the question of whether such policies should be redesigned to be more customer friendly.

An internal note recorded that FSA had successfully encouraged journalists who had contacted them about Equitable's position not to mention possible intervention by FSA on the grounds that "*a profitable run-off was the worst thing that could happen….[there was] no disaster in the making*". The note commented that there had also been several press articles criticising Equitable's current advertising campaign which cited their "*wonderous past*" without mentioning the more difficult present. The note concluded that it was understood that FSA had spoken to them and they were withdrawing their campaign.

14/11/00
FSA learned that although Equitable had withdrawn their new advertising campaign, they had not stopped advertising altogether. In a note of a telephone call made to Equitable to check on the position, FSA's prudential division said that they had told Equitable that they had been giving a "*fairly robust line*" to people who approached them, namely that the company was solvent and continuing to trade, so it was not a matter for FSA to be concerned about. The note concluded, however, that it was to be hoped that any future campaign would recognise the sensitivities and be presented with more tact.

An internal discussion paper was circulated by the prudential division, copied to GAD and the legal division, setting out how each of the possible outcomes of the bidding process might be handled and what the FSA's involvement should be. It noted that potential bidders had serious concerns about their own possible exposure to the seemingly unlimited exposure of Equitable to certain liabilities, including the apparent right of GAR policyholders to increase their cover, although Equitable had said that that exposure was less significant than had been suggested. The note also examined the regulatory implications of certain suggestions made by potential bidders as to how they might protect their own shareholders from an unacceptable degree of risk on acquiring Equitable. The prudential division concluded that, at that stage, there were no grounds for considering action on the basis of insolvency, as Equitable were able to meet their contractual obligations.

15/11/00
FSA's prudential division and GAD met another potential bidder, bidder C, to discuss how they intended to finance their proposed bid.

At a meeting with bidder A there was discussion about the possibility of ring-fencing GAR liabilities and limiting increments on GAR policies.

Bidder B told FSA's prudential division that they felt that, in the light of the results of the due diligence process they had carried out, it would not be worth taking Equitable "*at any price*". They said that, even if the whole of any purchase price were to be paid in to meet the shortfall in Equitable's funds, a great many policyholders would remain dissatisfied, which would make it impossible to continuing selling to them or to new policyholders under the Equitable name. They also said that some among the current policyholders were expecting a restoration of foregone bonuses and perhaps a demutualisation bonus, expectations it would be quite impossible to meet. They offered to take FSA through the actuarial assumptions they had made in their due diligence process. FSA's chairman told the director, in a manuscript addition to a note from the managing director, that he thought it would be helpful to understand bidder B's view. The prospects [for a sale] looked dimmer by the day and FSA needed to be bending their minds to what to do if no buyer was forthcoming or only on terms which were difficult for FSA to accept.

16/11/00
Commenting on the discussion paper of 14/11/00, GAD said that if no buyer were found, and Equitable intended to remain open to new business, they believed FSA would have to require Equitable to commission an independent investigation into their viability to write further business. They said that Equitable were very close to not covering their margin of solvency. There were uncertainties in, for example, the viability of the reinsurance agreement and in how financially resilient Equitable actually were - they were already "*unable*" to meet one of the resilience tests; it would be difficult to arrange a rescue by another insurer

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should they become technically insolvent. [GAD told my staff at interview that "*unwilling*" was intended rather than "*unable*", and that "*unable*" was in fact inaccurate.]

The managing director submitted a report to the FSA Board which said that there were three potential bidders for Equitable but that the "*due diligence process had revealed some concerns about how far liability for guarantees can be capped*" since the guarantees appeared also to apply to some future premiums. He said that FSA were exploring with Equitable the implications of this for the sale and for the expectations of future policyholders if Equitable continued to write new business.

Equitable's appointed actuary told GAD that their regulatory returns for 1999 assumed only 85% of benefits would be taken in GAR form. He said that the reserves held for contracts incorporating GAR options were 95.7% of the reserves that would be held if a 100% take-up rate were assumed. He listed a number of factors which he said influenced policyholders in deciding not to opt for the GAR, including the operation of Equitable's differential terminal bonus policy. While he accepted that that factor was no longer relevant, he said that in the three months that Equitable had been operating their current final bonus system, the take-up rate for GAR options had been 44%. He said that the GAR reserve was attributable between paid-up benefits and future premiums in the ratio of 3:1. Although the future premium assumption would need to be reviewed at the December 2000 valuation to reflect the experience of 2000, there had at that time been no significant up-turn in premiums since the Lords' judgment. He enclosed three reports: components of an Actuarial Appraisal of Equitable Life as at 31 December 1999, dated 25/08/00; Financial Projections of Equitable Life, dated October 2000; and Stochastic Financial Projections of the with-profits business of Equitable Life, dated 08/11/00. The reports had been prepared by the Equitable's actuarial advisers (from the same firm as their auditors) as part of a package to be provided to bidders. The appointed actuary raised a specific point about the approach taken to reserving in the conditions of the resilience tests. He said that Equitable's non-standard approach to resilience testing stemmed from the unusual nature of their recurrent single premium contract. He said that some of the prospective purchasers wanted confirmation that GAD considered Equitable's practice of making a charge of $^1/_2$% on accumulating with-profits pensions business to be reasonable, and would not require a change to that practice following the sale of Equitable. The appointed actuary said that the implication of the method he had applied was that there would be earnings in excess of the valuation interest rate used. He said he believed Equitable's approach was reasonable and invited GAD's comments.

In an internal memo FSA's prudential division said that one of the three potential bidders had withdrawn and set out the issues that had arisen during discussions with the two remaining potential bidders. They said that both appeared genuinely interested and were aiming to submit bids by 27/11/00, although they had both had reservations about continuing liabilities and potential compliance issues. One identified the main problem as the open-ended nature of Equitable's GAR liabilities. They had therefore drawn up proposals for the structure of Equitable after acquisition that would effectively cap any liability arising from policyholders with GAR options making additional payments under their policies. That would involve closing to new business Equitable's with-profits fund and creating separate GAR and non-GAR sub-funds. The GAR sub-fund would then comprise the reserves already calculated by Equitable as being needed to meet the GAR option liabilities, plus a goodwill payment for acquisition of the business; policyholders would still be able to make further payments, but the costs arising from those payments would have to be met from within the fund and could not be subsidised from the non-GAR fund. FSA's prudential division noted that both they and the bidder were seeking legal advice on the proposal. A manuscript endorsement by the chairman, dated 17/11/00, said that one bid (B) looked more promising, though he did not understand how they made the sums add up. The propositions by the other bidder (A) looked fraught with difficulty for FSA. Bidder A's proposals to use their estate to finance a deal was a dangerous issue and one where FSA had to proceed carefully.

FSA received a report by Equitable's actuarial advisors restating the 1999 year end position. They said that the impact of the new resilience test 2 was considered to be too strong and could in practice be mitigated by a release of prudent margins. The overall impact of the restatements, assuming a cash injection of £3.5bn, was for excess assets to increase from the actual position of £2.7bn to a restated position of £5.2bn. They pointed out that other approaches to reserving were possible which would lead to a need for higher or lower reserves, and they cited a number of examples.

17/11/00
FSA's prudential division wrote to two potential bidders who had expressed concern that Equitable's future profits implicit item might be withdrawn following a sale. They said that while FSA would be prepared to consider granting such a concession to the company taking over Equitable's business, they would have to consider any such request on a case by case basis.

The prudential division told the conduct of business division that if one of the bids was successful, those with GAR policies would find making top-up payments an attractive option, and this was expected to shift the GAR liability significantly upwards. As things stood, other policyholders would have to meet those additional costs, with the non-GAR policyholders being likely to end up subsidising the GAR policyholders. Bidder A were asking whether this would be regarded by FSA as mis-selling to those policyholders who did not have GARs.

The prudential division told the Chairman's Committee that the industry had made clear a strong wish to have FSA guidance on the implications of the Equitable judgment as quickly as possible, to remove uncertainty from the market place. They provided them with a draft guidance note.

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20/11/00
A conduct of business official replied to the prudential division that the minimum reasonable expectation of existing policyholders for new sales would be asset share. If asset share could not be promised then the warning that a buyer could get back less must be disclosed and could make Equitable unsellable. In other words, if the position was that bad, "*the closed fund*" option might be the only option.

FSA's enforcement director told the prudential and conduct of business divisions, in the context of comments on the draft industry guidance, that the fact that a company had ended up in a position in which it had either to breach its contractual obligation to the GAR holders or to disadvantage others was surely a failure of management and should be treated as such in terms of who pays. In a mutual company, where the policyholders were also the owners, they would bear that charge, but they bore the cost of management failures in any case, as that was a risk of ownership.

An officer from the prudential division asked colleagues and GAD whether any successor company to Equitable would be able to take advantage of their future profits implicit item. FSA had written to a bidder offering some comfort on the matter, but the prudential division needed to be clearer in their own minds what their own view on this was. It was worth doing this now since, while FSA should not seek to be drawn further on this, a fuller response would become critical to the bidder. As a matter of policy, section 68 orders for future profits implicit items were usually granted if the company was able to use them. The officer asked if there were any grounds on which FSA would recommend the Treasury not to grant such an order.

21/11/00
GAD told the prudential division that they agreed that Equitable's future profits implicit item could, in principle, be transferred to a company taking over the business. Another respondent commented that, as far as he was aware, "*we*" had never refused to grant a section 68 order for a future profits implicit item, although there had been disagreements over the figure.

GAD advised the prudential division on regulatory issues arising from proposals put forward by bidder B as to how they might fund a bid.

The prudential division told the FSA chairman of their discussion with bidder A over the use of inherited estate to finance the purchase of Equitable. The prudential division said that they saw no justifiable basis for such attribution on anything like the scale that would be of interest to the bidder. It was difficult to see how using their with-profits fund to support Equitable could be in the interests of bidder A's own with-profits policyholders.

22/11/00
An internal minute within the prudential division noted that if a successor company had an unlimited ability to scale back the benefits under GAR policies, so that insolvency was always avoided, this could potentially put policyholders in a worse position than if the transfer to the new company did not go ahead.

Equitable's appointed actuary sent the prudential division the estimated solvency position as at the end of October 2000; excess assets had fallen to £1.08bn.

A meeting took place between FSA's prudential division, GAD and a potential bidder to discuss their proposed bid. The bidder expressed concern that the liabilities to GAR policyholders could not be quantified, and said that they were exploring ways in which they might limit their exposure to that liability. They said that their current view of the value of Equitable's business, and the price that they might be prepared to offer, was rather less than they had previously thought. Funding of any acquisition would not now use free estate. It was recognised that certain aspects of the proposals could give rise to concerns from a conduct of business point of view and there were some compliance issues which the bidder had identified; FSA therefore agreed to consider the possibility of a meeting between the bidder and both prudential and conduct of business regulators. The potential bidder was also concerned at the possible implications for them, were they to purchase Equitable, of the continuing enforcement action against Equitable.

The Chairman's Committee met and discussed the matter of guidance that FSA were proposing to issue to the industry following the House of Lords' judgment. It was agreed that Counsel's advice should be sought as to what actions it would be reasonable for FSA to take in that regard, and the risks involved.

23/11/00
GAD replied to Equitable's letter of 16/11/00, questioning the consistency of their approach to GAR reserving with the Government Actuary's 1999 guidance and the method and assumptions used in assessing the GAR liability on future premiums. In particular, they asked for justification of an assumption that premiums on contracts containing GAR options would reduce by 20% annually; the effect on the resilience reserve of a number of modifications in Equitable's method of calculation; and the appropriateness of the fi% charge on accumulating with-profits business. Equitable's actuarial advisers had said that removing the charge would increase Equitable's liabilities by £950m. GAD also asked whether reserves were adequate to provide for the flexibility afforded to policyholders by virtue of the fact that benefits could be taken over a wide range of ages, with the full value of any GAR and with no market value adjustment.

The prudential division received a call from Equitable updating them on progress on the sale. A note of the call said that, while no mention had been made of the price that might be offered, Equitable's managing director

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appeared to have more realistic expectations than a few weeks previously.

A conduct of business officer e-mailed a colleague (copied to the prudential division), saying that Equitable had settled a complaint by a GAR policyholder by making an immediate payment with a further similar payment to follow in three months time, provided the policyholder did not comment to the press and issued no defamatory information about Equitable. The officer noted that other Equitable issues that FSA's conduct of business division were looking at included: the impact of the GAR ruling; GAR selection of annuity type review; pension fund withdrawal disciplinary action; the response to the PIA visit report of August 2000; and advertising issues relating to Equitable's past performance, and poor present situation.

The director reported to the managing director and the chairman the position on one of the bids. The bidder (A) would put just under £1bn into Equitable, a much lower figure than had at first been thought. The bidder saw the pension fund withdrawal enforcement case as a potential show-stopper because of the likely reputational damage and the cost of any resulting compliance changes required. They were seeking comfort from FSA on two key issues: the structure of Equitable funds post-acquisition and transitional arrangements to preserve the value of the business between a recommendation being made to policyholders and a vote being held, since they were very concerned that the value of Equitable would erode away rapidly between a recommendation being made by the Board and voted on by the members.

24/11/00
Bidder A wrote to FSA's prudential division setting out proposals which they believed would enable them to limit, and therefore to calculate the required level of reserving for, the GAR liability.

The director sent the managing director a memorandum about the options available to Equitable if no sale were to be achieved, which he copied to the chairman and the conduct of business director. He said that Equitable were covering their required minimum margin but there were doubts about their interpretation of guidance and adherence to recommended resilience tests. They could strengthen their reserves by £1bn and still only just meet the required margin. The memo listed the various options open to Equitable to improve their statutory and realistic financial position.

GAD submitted their detailed scrutiny report on Equitable's 1999 regulatory returns giving them a priority rating of 2. They said that although at first sight the solvency position looked reasonable, with available assets of £3.861bn to cover a required minimum margin of £1.114bn, that figure included a future profits implicit item of £925m, disregarded liability to repay a loan of £346m, and benefited from a reduction in liability of almost £1.1bn resulting from the reinsurance agreement. Without those factors, the available assets would reduce to £1.511bn.

The report also noted that the aggregate asset share was close to the value of the fund [i.e. there was no estate]; that reliance on the reinsurance agreement was not wholly satisfactory from a regulatory point of view, as it removed over £1bn from Equitable's liabilities but would not be available in the event of insolvency; that the assumption of 85% take-up of GARs was lower than had been specified in guidance note DAA13 (though it was recognised that any take-up in excess of 60% would be met by the reinsurance treaty); that Equitable were exposed to falls in the equity market (a fall in the market of 15% being enough to leave them unable to cover the required minimum margin); and that Equitable would be unable to reinstate the seven months loss of bonus unless funds were made available by a prospective purchaser. It said that the question of whether Equitable should continue to sell non-GAR policies in a common fund with GAR policies could be considered an "*environment risk*".

FSA's Firms and Markets Committee met. They noted that the sale was becoming increasingly complex and, while two bidders remained, it was far from certain that a sale would take place. The Committee discussed regulatory issues that they felt might arise from proposals that had been put forward by one of the remaining bidders and noted that the prudential division were considering what action would be required if neither bid were successful.

In response to the director's report of 23 November on bidder A's bid, the chairman queried whether the Equitable Board would be able to act on one of the bidder's proposals (which, he said, would alienate the Society's assets and appeared to leave policyholders with Hobson's choice) without policyholder approval, and asked for clarification of the FSA's role if Equitable did carry it through.

27/11/00
The prudential division told Equitable that it was likely - though not certain - that eligibility for a section 68 order permitting a future profits implicit item could be transferred to an acquiring company. They said that, as a matter of policy, orders in relation to an implicit item for future profits had generally been granted when relevant requirements were met.

GAD told the prudential division that in their view the proposals contained in bidder A's letter of 24/11/00 would not meet policyholders' reasonable expectations, and would appear even to undermine the concept. They said that, in effect, the proposal relied heavily on things turning out for the best, exactly the philosophy that they said had given rise to complaints about Equitable's current management. It was possible that bidder A had reached the view that Equitable could not be saved and was looking to acquire the sales force and administrative capability at a low price.

In an internal memo, the prudential division reported the outcome of a meeting that they had attended with the enforcement division and Equitable about the sale of pension fund withdrawal contracts. Before the meeting the

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prudential division had told the conduct of business division of their concerns that regulatory action - and punitive fines in particular - would be detrimental to the interests of policyholders, and that such action could disrupt or even destroy the sales process. They said that the enforcement division had appeared "*uncomfortable*" with the idea that they should take such factors into account. The enforcement division and Equitable had agreed at the meeting that adjustments would be made to Equitable's procedures in respect of such sales, though they had been unable to agree on the question of whether a review of contracts already sold was necessary. The enforcement division had undertaken to keep the prudential division informed of progress.

The prudential division noted the outcome of a meeting that they and the conduct of business division had attended with bidder A. They said that the meeting had concluded that, in PIA marketing terms, bidder A's proposals were workable, but would require some rule waivers which would have to be approved by the PIA Board. Bidder A were to write to PIA highlighting the issues and PIA would then make a case for the waivers to be put to their Board; the memo said that that would probably fall to the conduct of business division to deal with. The prudential division would probably be asked to make a contribution to that submission, setting out the implications should the bid fail. The one potential show-stopper was if PIA should decline the request for the rule waivers. If that happened the deal lost commercial viability for the bidder.

GAD advised the prudential division in respect of certain aspects of proposals submitted by another potential bidder, bidder C, concerning funding of the bid. They said that they remained unconvinced of bidder C's arguments in support of the proposals, but would need more information if they were to comment further.

28/11/00
The prudential division wrote to bidder C setting out further information that they would need to see before reaching a conclusive view on the proposals.

The prudential division, with GAD, met bidder A (see entry for 30/11/00).

According to the FSA Board minutes, the managing director reported on developments in the Equitable case and agreed to report further to the Board at its next meeting.

The prudential division told GAD and the legal advisers that article 4 of Equitable's constitution seemed to remove from policyholders any current protection there might otherwise have been for them under the Policyholders' Protection Act 1975.

The prudential division set out for members of FSA's Directors' Committee the options open to them concerning the proposal to issue guidance to the industry.

29/11/00
The prudential division wrote to Equitable suggesting a meeting to discuss a number of issues that had arisen during discussions with potential bidders.

Equitable's appointed actuary replied to GAD's letter of 23/11/00. He said that he had explained in his letter of 16/11/00 that his assumption as to the level of take-up of GARs was consistent with the Government Actuary's guidance that the reserves held for GARs should not be reduced by more than 5%. If the guidance had meant that the actual take-up, rather than the effect of that on the reserves, should be no less than 95%, then he would need to reflect that in the 2000 returns. He provided justification for the $^{1}/_{2}$% per annum charge and the assumption of 20% annual reduction in future payments into GAR policies (saying that relevant premium income had declined by 25% per annum over the years 1997 - 1999). He also set out arguments in support of his approach to resilience reserving.

In a memo to FSA's managing director and the chairman, the prudential division said that two bidders - A and C - remained; but for reasons relating to their respective plans for Equitable following acquisition, Equitable saw bidder A as the clear front runner. The prudential division went on to say, however, that bidder A had made clear to them that any bid they might make would be on stringent terms and so might come as an unpleasant surprise to Equitable policyholders. Bidder A were nervous about the potential effect of a number of compliance issues. These included: the enforcement action in respect of pension fund withdrawals; the consequences of a PIA visit in June; the position of pensions sales since the Lords' judgment; and the extent to which the new management might be held responsible for sales made by Equitable after the deal had been announced, but before the scheme had become effective (in practice, the prudential division said, this related to top-up payments on existing policies). Bidder A would decide by the end of the week whether a bid made sense for them in overall economic terms, and would submit a recommendation to their Board on 7/12/00. The memo listed a number of issues which needed addressing, and on which a common understanding with FSA needed to be reached, before the bidders could reach a decision on a bid. The memo was copied to the conduct of business division.

GAD told the prudential division that, if they were to close to new business, Equitable might have to make further cuts in bonus rates, perhaps up to 10%. That might be a significant factor discouraging bids.

The prudential division, with GAD, had a further meeting with bidder A.

30/11/00
The prudential division sought Counsel's advice as to whether it would be appropriate to issue guidance to the industry on the House of Lords' judgment, and on the form that any such guidance should take.

The prudential division circulated an e-mail internally and to GAD (though not to the conduct of business division) suggesting an agenda for a proposed meeting with Equitable to include: Equitable's view of the bidding process and whether they were still confident of securing a deal; what contingency plans they were making; Equitable's response to GAD's letter on reserving (23/11/00); PIA issues; and Equitable's rectification scheme.

In an internal memo the prudential division reported details of the meeting that they had attended on 27/11/00 with the conduct of business division and bidder A to discuss certain aspects of the proposed bid. The memo also noted that a further meeting had taken place on 28/11/00 between bidder A and the prudential division. The meeting had discussed remaining areas of concern to the bidders namely: marketing; the reputational risk associated with any enforcement action (in relation to alleged pensions mis-selling); reserving issues including bidder A's hope that the acquired with-profits business would continue in a separate ring-fenced fund; and the protection that Equitable's articles of association afforded to limit the exposure of the successor company not only to discretionary liabilities but also those provided for under contract [which included top-ups]. The memo said that bidder A and the prudential division had also explored ways to limit bidder A's exposure to discretionary benefits while protecting (on the face of it) contractual guarantees. Bidder A had indicated that that did not provide sufficient protection to their existing policyholders or shareholders and accordingly they would not be able to proceed with an offer on that basis.

The prudential division circulated a paper which set out options for further action on the possible issue of guidance to the industry. That said that, having reviewed their own practices, a number of insurers were taking a similar approach to that now adopted by Equitable, (namely paying the full bonus rates to GAR and non-GAR policyholders) and offering compensation to those already retired.

An internal GAD e-mail expressed doubts about whether Equitable's proposals of 29/11/00 as regards the $^{1}/_{2}$% Zillmer adjustment assumed in the resilience scenario were consistent with the regulations either before or after the 2000 amendments, and so would not be acceptable in the regulatory returns for 2000.

01/12/00
A meeting took place between the prudential division, GAD and Equitable. According to the prudential division's note of the meeting, Equitable confirmed that one of the potential bidders had pulled out two weeks earlier, but remained interested in acquiring the sales force and infrastructure. Another bidder was contemplating a very small offer price, with no goodwill element for policyholders. The other remaining realistic bidder's proposal would involve the immediate sale to them of the sales force and infrastructure and would not allow Equitable an opportunity to consult their members before doing so. It was noted that that gave rise to concerns both for Equitable and FSA; FSA were reported to be considering the implications of the proposal. Equitable's managing director did not know how much bidder A intended to offer, and said that it was possible that the sum would be insufficient to allow Equitable to proceed with a sale. Should that be the case, then it was likely that the company would close to new business and sell the sales force and infrastructure. It was noted that disagreement remained between GAD and Equitable as to the interpretation of the requirement to reserve on the assumption of 95% take-up of GAR options; Equitable's appointed actuary confirmed that actual take-up was below 50%. There had been some discussion about Equitable's use of the $^{1}/_{2}$% Zillmer reduction when calculating the resilience reserve, a practice which the appointed actuary confirmed had been followed since the early 1990s. GAD said that it was not in accordance with the regulations and they had understood, from conversations with the appointed actuary's predecessor, that Equitable would not make such a reduction. The appointed actuary agreed that the assumption of 20% annual reduction in GAR premiums had to be reviewed. Equitable had not considered whether policyholders who had joined after the House of Lords' judgment could be excessively disadvantaged in a closed fund, since from that date it had been known that preferential treatment would be given to GAR policyholders. Equitable's managing director confirmed that the sales force had been adequately briefed and instructed to advise potential policyholders of the company's circumstances. He said that Equitable had taken legal advice as to whether they should continue to write new business.

GAD provided FSA's prudential division with comments on the appointed actuary's letter of 29/11/00. They said that Equitable's assumption of the GAR take-up rate should increase from 85% to 90%; however, that would not lead to an increase in net reserves while the reinsurance treaty remained in place. They also said that they did not accept the use of $^{1}/_{2}$% allowance for expenses, and were not happy with an assumption that the appointed actuary had made of a 20% annual reduction in payments into GAR policies. The use of the new resilience test 2 would increase the resilience reserve by £600m (although that would reduce to £300m if a different concept were used but there would have to be an offset against another reduction in the resilience reserve). They set out a number of other points on which there was at least a possibility that the appointed actuary's calculations would have to be amended, and said that the net result of all such amendments would be to reduce Equitable's solvency margin from £1,080m to £70m. [An arithmetical error in GAD's calculations which was later found by the prudential division meant that £70m should have read £20m.] Were the reinsurance treaty to be terminated, liabilities would increase by approximately a further £1bn (or with the treaty in place £500m at 12/99 given a 60% threshold). [That is, if only 60% of GAR policyholders took up the GAR option or if any liability over 60% was covered by reinsurance.] GAD said that would mean that Equitable would be very close to not covering their required minimum margin.

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The prudential division noted in an internal memorandum that conversations with the two remaining potential bidders had suggested that they might both be about to pull out of the process. It might therefore become clear as early as 08/12/00 that no bid would be forthcoming; FSA and Equitable would then need to be ready to respond quickly. A very early announcement by Equitable that they were closing to new business would be preferable. For their part, the prudential division would need to be ready to explain the regulatory implications, and why they had not forced closure immediately after the House of Lords' judgment or possibly even earlier.

FSA's Firms and Markets Committee met and noted that they were to meet the takeover panel to seek advice on one aspect of proposals put forward by one of the remaining potential bidders. They were told that an announcement regarding a bid was expected during the week beginning 18/12/00.

FSA's managing director told the prudential division that the draft guidance to the industry of 30/11/00 was a great improvement although he thought that the recommended option would still get a "*pretty rough time*". He added that FSA had to accept or challenge companies' returns; they had at some time to make a judgment themselves about the decision each company made.

At a meeting with FSA's prudential and legal divisions, Counsel advised that any guidance that FSA might issue should avoid trying to instruct firms as to how they should interpret the House of Lords' judgment. Counsel advised telling firms that it was their responsibility to consider what implications the judgment might have for their own particular circumstances, and offering general guidance only on the matters that such consideration should take into account, including the need to take legal and actuarial advice.

04/12/00

GAD wrote to Equitable's appointed actuary following up a number of points raised at the meeting of 01/12/00. They disputed Equitable's assumption of 85% take-up rate of GARs, arguing that in Equitable's particular circumstances it would not be prudent to assume a take-up rate lower than 90%; they pointed out that the actuarial advisors had assumed a 10% reduction in future payments into GAR policies (as opposed to Equitable's assumption of 20%), and said that they would therefore be looking for a stronger assumption in that respect at the year end; and they added that the use of the $\frac{1}{2}$% charge was causing them particular concern and would not be acceptable in the returns as at 31/12/00. They also asked for further clarification on certain aspects of the actuary's approach to resilience reserving.

Bidder C notified FSA's prudential division that they had decided to pull out. They said that through the due diligence process they had identified material risks for their own shareholders were they to proceed on the basis that they had proposed; unusually that risk could not be factored into the purchase price since a lower price simply increased the risks. They had considered a different approach to acquisition, by which they believed that it might be possible to restore Equitable to a viable business by converting it to a unit-linked business. If that option were to be pursued, however, they would want a period of exclusive negotiation, to which Equitable had been unable to agree. Bidder C had indicated that they might be interested in reopening discussions were Equitable to agree to their terms.

In an internal memo FSA's prudential division reported a conversation with the remaining bidder, bidder A, who said that they were becoming increasingly concerned that acquisition of Equitable would be uneconomic. They said that the price that they might be prepared to pay could be significantly lower than had previously been discussed, and might be at such a level as to be unattractive to Equitable's members. Any goodwill associated with a sale might then be lost. They said that the bid was to be considered by their Board on 07/12/00 and that it was not possible to predict the Board's decision. While it was recognised that bidder A might simply be attempting to pave the way for a substantially reduced offer, the memo suggested that their comments be taken at face value, since they echoed what others had said. The memo also suggested, however, that FSA continue with the preparations and analysis already in hand, so as to be ready to respond quickly should the sale go ahead.

A letter from FSA's enforcement division to Equitable, which was not copied to FSA colleagues, said that PIA required Equitable to meet their concerns and suspend sales of pension fund withdrawal products until they could demonstrate compliance with PIA rules, amend the process for new business in that area, and provide a project plan for a review by Equitable of its past business. A reply by 15/12/00 was required.

In another internal FSA memo, the relevant director noted that if an offer were made for Equitable, FSA would have considerable difficulty making a decision on it as quickly as the buyer would wish as the issues for them were complex and, at least presentationally, extremely awkward. They needed to start preparations, however, in case they needed to use their formal intervention powers, and he asked for a paper outlining the possible outcomes of the bidding process and the relevant issues to be addressed as a result of each.

05/12/00

The prudential division sent the FSA managing director a briefing note, in preparation for a meeting he was to attend with Equitable's chairman and managing director, in which they said that Equitable had free assets of £70m above the required minimum margin - a margin that was uncomfortably tight. [Due to a typing error, the original note said £7m but the file copy seen by OPCA had been corrected in manuscript to £70m (see second entry of 01/12/00). In fact GAD had made an arithmetical error in that calculation and the net outcome of the various possible adjustments they had considered on 01/12/00

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should have been a figure of £20m.] The prudential division said that was £1,010m [correctly £1,060m] less than Equitable's own estimate (as at end October), the difference being attributable to possible adjustments that GAD had considered to various assumptions in the reserving basis that had been raised by the auditors to bring the assumptions into line with what GAD would normally expect. The prudential division believed that if no bid were forthcoming, they would have grounds for closing Equitable to new business, either for failing to meet the required minimum margin or because of the risk that policyholders' reasonable expectations would not be met, but they would prefer Equitable's directors to take that decision.

FSA's managing director proposed an urgent meeting of the Tripartite Standing Committee (paragraph 37) to consider the possible impact of the worst foreseeable outcome (closure of Equitable to new business) and the steps to be taken as a result.

In an internal memo FSA's prudential division said that they had received legal advice to the effect that they had no powers to prevent Equitable from accepting top-up payments to GAR policies.

In a briefing note for the Tripartite Standing Committee, copied to the Treasury, the prudential division said that only three of the 15 companies who had expressed an interest had shown a serious interest in taking over Equitable. All had considered it not to be a viable prospect. Equitable were only just meeting their minimum capital requirement; although they had around £2bn in their Companies Act accounts, that would be exhausted were equity markets to fall by around 20-25%. The prudential division said that Equitable would have no choice but to close to new business, although they would continue to operate as a closed fund [that is, to service only existing policies]. While a number of closed funds had been acquired by third parties, who had then provided capital support, that had not proved to be a feasible option for Equitable. Allowing Equitable to accept further premiums on GAR products [i.e. to make top-ups] would disadvantage other policyholders. While guaranteed benefits would continue to be met in full, there were likely to be cuts in bonus rates over the next few years.

The Chairman's Committee considered the implications, both for Equitable and for the industry as a whole, if the one remaining bidder withdrew, which seemed increasingly likely. If that happened, Equitable would have to close for new business, but FSA thought it preferable that they did so voluntarily. It was agreed, however, that FSA now needed to plan on the assumption that the final bidder would pull out, and that Equitable would then need to make a quick decision about closure. If Equitable did not volunteer to close to new business, then FSA would need to consider their financial viability. It was considered that FSA had the powers to close the company under section 45 of the 1982 Act (paragraph 34). The Committee agreed that that would address the initial situation, but that it would also be important to resolve the issue of whether there was any scope for FSA to prevent policyholders with GARs from topping up their policies. The Committee also considered the advice that had been obtained from Counsel on the proposed guidance following the meeting of 29/11/00.

The head of prudential supervision told the managing director and prudential division colleagues that GAD had clarified how thin and fragile Equitable's margin was. If there was no prospect of a sale Equitable would be told that FSA could not allow them to continue to trade, although they might consider allowing a period of grace for a few weeks to allow them to effect a fire sale of bits of the business.

06/12/00
FSA's senior legal officer commissioned some work so that FSA would be in a position, if need be, to be able properly to exercise their formal intervention powers against Equitable later that week. The first possible ground he saw for doing this was that Equitable were unable to meet their liabilities to policyholders; this was problematic as (in his view) their article 4 limited their liability to policyholders to the amount of their assets. [This view was not shared by the Treasury.] The second ground related to the interests of policyholders and potential policyholders; FSA would need a view on whether the action proposed was a proportionate way to protect the interests of those policyholders. The third ground was sound and prudent management which, he said, must be exercisable. Finally FSA might act on the ground that Equitable might be unable to fulfil the reasonable expectations of long term business policyholders; this seemed highly likely to be exercisable.

A meeting took place between the prudential division, GAD, and Equitable. Equitable were aware that the one remaining bidder was unlikely to make an offer; the bidder would make a formal decision at a board meeting on 07/12/00. Equitable said that if no bid emerged, they would close the with-profits fund and very likely the unit-linked business too. The prudential division explained that they would have a problem in allowing them to continue to write unit-linked business because it appeared that those funds could then be used to meet Equitable's wider liabilities; Equitable accordingly agreed that if no bid were forthcoming they would close to all new business.

The Tripartite Standing Committee met. Equitable's position and the impact of their closure on other companies were discussed. It was agreed that Equitable's position was unique and there should not be significant industry repercussions. While there was no systemic threat, three important stakeholders were Equitable's staff, their policyholders and the markets. Policyholders should be encouraged not to rush into decisions. It was noted that Equitable could not refuse top-up payments from with-profits holders with GARs, even though they would potentially harm non-GAR with-profits policyholders. FSA said that that was why, given Equitable's lack of substantial surpluses, if no sale was likely they could no longer prudently write new business. If Equitable had not

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reached that conclusion themselves, FSA would have been looking to step in and prevent them taking new business. As to why earlier action had not been taken, FSA would explain that there had until then been a reasonable expectation of a sale, which closure to new business would have destroyed. [In what the Treasury say is the initial detailed draft note of the meeting, the Treasury asked if "*we*" should have stopped Equitable putting out so many advertisements recently. FSA said that, following a FSA phone call about a month earlier, the advertisements had been scaled down, but that might also have been a response to adverse press comment. That exchange did not appear in what the Treasury say is the final version of the meeting note.]

Treasury officials briefed the then Economic Secretary that the last remaining bidder for Equitable was likely the next day to decide against bidding and Equitable would then close to new business, possibly causing a ripple in the gilts market and leaving 650,000 policyholders looking for advice. The main reason that a sale had not taken place was said to be that it was impossible to cap Equitable's GAR liabilities. Equitable were only just meeting their capital requirements, so there was little working capital available to underpin the writing of new business. FSA estimated that the impact of the Lords' judgment would be to reduce returns to policyholders by 10%; however, such returns would still compare well with those of many of Equitable's competitors. While it might be argued that the regulator should have stopped Equitable writing new business sooner, there had until a few days previously been every sign that a sale could be achieved. The regulators had been just as surprised as the markets that no buyer could be found. The briefing said: "*Does this event show up a deep-seated oversight on the part of the regulator? Probably.*" [in failing to ensure that proper risk management processes were in place at Equitable] but the briefing added that the oversight was not life threatening until the Lords' judgment, the scope of which had been quite unexpected.

FSA's Directors' Committee met to discuss the advice that had been obtained from counsel on the guidance that it was proposed to issue in respect of the House of Lords' judgment. The Committee agreed to amend the draft guidance in line with Counsel's advice and submit it to the Board.

07/12/00
Bidder A withdrew from the bidding process.

08/12/00
Equitable closed to new business.

FSA's Firms and Markets Committee met. They considered that the circumstances which had led to the closure of Equitable to new business were largely unique to the company. The company would now "*go into solvent run-off*" and there would be a need to calm any panic reaction by policyholders. The minutes of the meeting said "*It was queried whether proper disclosure about the firm's position had been made since the House of Lords' judgment. It was suggested that, if it had not, policyholders might be able to claim compensation for mis-selling. There might also be a need to consider disciplinary action*." It was noted that the pension fund withdrawal disciplinary case was still on-going and could cost Equitable a further £30m.

13/12/00
The eighth quarterly meeting took place between the Treasury and FSA's prudential division. According to the Treasury's note of the meeting, they asked whether there would be a FSA internal enquiry into Equitable. The prudential division said that a paper was being prepared to put before FSA's Board on options available to the company, and whether there were any lessons to be learned, but that any decision making that might have contributed to Equitable's problems would have been the responsibility of DTI. The director explained that there had been three heavyweight bidders at the outset with bidder A the most realistic and likely option. However, ring-fencing the GAR liability by buying out the options would have cost bidder A over £1bn and they could not afford to do this in addition to the launch of stakeholder funding. He said that neither FSA nor Equitable had realised the extent of the GAR liability which was usually dealt with by varying the terminal bonus. The GAR liability was thought to have been capped. FSA had not appreciated the scale of the problem; they said that it had been a "*wake-up call*" for them and for the industry to review their structure and their strategies. Regarding allegations that had been made of mis-selling after the House of Lords' judgment, the prudential division said that, although a script provided to Equitable's sales force by the company had not dealt with the problems, it would have been unreasonable to stop the company from continuing as a going concern while a sale was anticipated. The Treasury questioned the role of Equitable's appointed actuary. As for Equitable's auditors, the prudential division were reported as saying that the Lords' judgment had been completely unexpected and that the management of the company would have been more culpable. They suggested that any action taken against the auditors would probably have a realistic chance of success only in respect of the period after the House of Lords' judgment, in which case liability would be small and easily managed.

15/12/00
The FSA Board noted a paper by the managing director saying that FSA judged the main reason for the last three potential bidders for Equitable dropping out to be that, as the bidders went through the due diligence process, they had concluded that:

- GAR policyholders could put in very large amounts of extra money that would also benefit from the guarantees; the stronger the acquirer the greater the incentive to put in more money. This together with uncertainty on future interest rates made it difficult to estimate the eventual liability.

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position had been made since the House of Lords' queried whether proper disclosure about the firm's ... (upside-down reprint of the same page content)

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- All existing policyholders seemed to be expecting a large payment for the sale of the Society. Interested buyers were thus faced with the choice of either paying far more than they thought Equitable was worth or paying less for "*goodwill*" and finding that there was "*bad will*".

The managing director said that while Equitable were still meeting their solvency requirements the decision to stop new business had been taken because they lacked the resources to underwrite new business convincingly. FSA had been prepared to intervene but Equitable had already decided to close to new business so no use of FSA powers had been necessary. So far as the actions of FSA were concerned, he said that it was worth noting that by end 1998 FSA were requiring reserves in the statutory accounts that the whole industry felt were excessive. He also commented, in respect of the "*accusation*" that FSA should have made Equitable explain the implications to potential new members (some 15,000 policies had been sold between the Lords' judgment and early December) and/or limited its advertising, that this raised some important issues. Equitable were obliged to ensure that their sales did not involve misleading representations; if they did this was grounds for a claim for redress. On that basis, hitherto, FSA had generally been reactive in monitoring advertising.

19/12/00
A bilateral meeting took place between FSA's prudential and conduct of business regulatory divisions. This was the first such meeting since August; there was no meeting in October. The current position and future action were discussed.

2001

05/02/01
Equitable announced the sale of their operating business to the then Halifax Group plc who paid £500m, with the prospect of a further sum of up to £500m to follow. Half of the latter sum was conditional on Equitable's policyholders agreeing to cap the GAR liabilities - which they subsequently did - and the remainder on the sales force meeting certain performance targets.

31/08/01
The then Economic Secretary announced the setting up of the Penrose Inquiry.

17/10/01
Baird report published to Parliament.

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Appendix D

Declining interest rates and GAR values

The table below shows how the value of the GARs increased over time as interest rates generally fell. The table shows, year by year, how current annuity rates fell substantially below the guaranteed rates in the GAR policies and rapidly increased their potential value to the GAR policyholders.

Effective bonus date	Typical excess of GAR over current annuity rate at bonus date
1/1/94	10%
1/1/95	-2%
1/1/96	7%
1/1/97	10%
1/1/98	18%
1/1/99	41%
1/1/2000	33%

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Effective bonus date | Typical excess of GAR over current annuity rate at bonus date
1/1/94 10%
1/1/95 -2%
1/1/96 7%
1/1/97 10%
1/1/98 18%
1/1/99 41%
1/1/2000 33%
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