

# The Office of Sir John Chadwick

Appointed by HM Government as independent adviser in relation to The Equitable Life ex-gratia payment scheme

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## Equitable Life ex-gratia payment scheme

### Second Interim Report

December 2009



# 1 INTRODUCTION

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- 1.1 In a document published on 15 June 2009 (“the Proposals”) I set out provisional views as to the issues which I should address in carrying out the task for which I had been appointed by HM Treasury: to advise the Government on matters arising from its Response to the Report of the Parliamentary Ombudsman on her investigation into the prudential regulation of the Equitable Life Assurance Society (“the Society” or “Equitable Life”). At Section 2 of the Proposals, I set out those of the findings of maladministration and injustice made in the Report which had at that time been accepted by the Government.
- 1.2 On 18 August 2009, I submitted to HM Treasury an interim report (“the First Interim Report”), to which I attached representations which had been made to me in response to the Proposals. In that First Interim Report, I identified the issues which, in the light of those representations and on further reflection, I then considered that I would need to address.
- 1.3 On 15 October 2009 the Administrative Court handed down judgment in *R v HM Treasury, ex p Equitable Members Action Group* [2009] EWHC 2495 Admin (“the Court” and “the Judgment”). The Court upheld the Government’s decision to reject the Ombudsman’s recommendation as to the establishment of a tribunal to determine the amount of compensation payable to policyholders; upheld the Government’s decision as to the Terms of Reference upon which I had been appointed (Annex A to the Response); but set aside the Government’s decision to reject certain of the Ombudsman’s findings of maladministration and injustice.
- 1.4 On 20 October 2009 the Chief Secretary to the Treasury informed the House of Commons that the Government had decided to accept those findings of maladministration and injustice which, as the Court had held, it had not been entitled to reject (“the newly accepted findings”). On 26 November 2009, the Government laid before the House Revised Terms of Reference (Cm 7762). The Revised Terms of Reference require that, in addition to the matters in respect of which I was appointed to advise in January 2009, I am now to advise:
- (i) as to the extent of the relative losses suffered as a result of the newly accepted findings and
  - (ii) on the nature and extent of (a) the Ombudsman’s fifth finding of maladministration and the finding of injustice in relation to that fifth finding and (b) the finding of injustice in relation to the Ombudsman’s second and fourth findings of maladministration (so far as the fourth finding is now accepted).
- 1.5 In Section 2 of this Second Interim Report I set out the passages of the Ombudsman’s Report and the Government’s Response which identify, and define the scope of, the newly accepted findings.
- 1.6 In my First Interim Report, I identified some of the difficulties inherent in adopting what I there described as a “Report-based” approach to the assessment of relative loss. I explained that these difficulties could be avoided (or, at least, substantially reduced) if I were to adopt what I described as a “flexible” approach. I invited representations upon the question whether my Terms of Reference permitted me to adopt the flexible approach. I have considered the representations made to me on that question; and have concluded that my

Terms of Reference do not preclude the flexible approach to the assessment of relative loss. In Section 3 of this Second Interim Report I set out the reasons which have led me to that conclusion.

- 1.7 I have sought to identify the principal issues that I will need to resolve in assessing relative loss on the basis of the flexible approach. In Section 4 of this Second Interim Report, I set out those issues; together with my current (and provisional) views. I invite representations on these issues.
- 1.8 In Section 5 of this Second Interim Report, I set out my understanding of the scope of the advice now sought in relation to the Ombudsman's second, fourth and fifth findings.
- 1.9 In Section 6, I set out questions which, as it now seems to me, I shall need to answer in order to complete my work. I invite representations as to how all or any of those questions should be answered.
- 1.10 Finally, in Section 7, I set out some further thoughts on the issue of apportionment; and invite representations on the approach that I should adopt to that issue.
- 1.11 At the same time as this Second Interim Report, I submit to HM Treasury for publication a document titled, "Correspondence regarding my First Interim Report of August 2009" ("the Correspondence"). Copies of the Correspondence will be available from my Office on request; alternatively it may be reviewed at the website [www.chadwick-office.org](http://www.chadwick-office.org). I invite those who wish to understand my work more fully to read the Correspondence: the letters that I have received and which are reproduced there have in many respects informed this Second Interim Report.
- 1.12 Representations and comments in response to this Second Interim Report should be made in writing and sent to:
- The Office of Sir John Chadwick  
One Essex Court  
Temple  
London  
EC4Y 9AR  
Email: [info@chadwick-office.org](mailto:info@chadwick-office.org)
- 1.13 It will assist the orderly progress of my work if those who wish me to take account of their representations ensure that they are received by my office no later than 29 January 2010. I expect to make one further interim report before completing my work and submitting a final report.
- 1.14 For information about my Office, please refer to its website at [www.chadwick-office.org](http://www.chadwick-office.org).



**The Right Honourable Sir John Chadwick**

## 2 NEWLY ACCEPTED FINDINGS

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- 2.1 In this Section I set out the passages of the Ombudsman’s Report and the Government’s Response which identify and define the scope of the newly accepted findings of maladministration and injustice. References to the Report are in the form Part/Chapter/Paragraph. Page numbers are given for additional ease of reference.

### Second finding of maladministration: scrutiny of Equitable Life’s regulatory returns 1990-1993

- 2.2 The Ombudsman’s second finding of maladministration is at Report 1/11/40 (page 319):

*“I find that the failure by GAD, as part of the scrutiny process, to question and seek to resolve questions within the Society’s regulatory returns for each year from 1990 to 1993, related to (i) the valuation rate of interest used to discount the Society’s liabilities and (ii) the affordability and sustainability of the Society’s bonus declarations, constitutes maladministration.”*

That finding reflects an earlier finding (Report 1/10/202, page 249) to the effect that the failure identified “fell short of what could reasonably be expected of GAD”. The Report contains a more detailed summary of the matters found to constitute maladministration at paragraphs 1/11/28-39 (pages 318-319); and an analysis, at greater length, at paragraphs 1/10/132-201 (pages 239-249).

- 2.3 The Government accepted this finding of maladministration at paragraph 4.30 (page 16) of the Response. At paragraphs 4.32-33 (page 16) the basis for that acceptance was explained:

#### **“Valuation interest rates**

*4.32 The Government accepts that GAD did not raise any query based on Equitable Life’s regulatory returns for 1990 as to Equitable Life’s approach to valuation interest rates. The Government also accepts that it would have been appropriate for GAD, in the course of its review of Equitable Life’s regulatory returns, to raise such a query given the level of Equitable Life’s valuation interest rates. In relation to Equitable Life’s returns for 1991 to 1993, GAD did seek further information as to Equitable Life’s approach to valuation interest rates in correspondence. However, it is accepted that GAD did not satisfactorily resolve those issues.*

#### **Affordability and sustainability of Equitable Life’s bonuses**

*4.33 The Government accepts that GAD did not question Equitable Life and resolve concerns which it held internally about Equitable Life’s ability to pay future bonuses in a way which did not adversely affect PRE. It is clear that GAD held concerns about Equitable Life’s bonus policy and the Government agrees that it would have been appropriate for GAD to have raised these concerns with Equitable Life. It is therefore accepted that GAD did not satisfactorily resolve these issues.”*

## Fourth finding of maladministration: scrutiny of Equitable Life's regulatory returns 1994-1996

- 2.4 The Ombudsman's fourth finding of maladministration is at Report 1/11/60 (pages 321-2):

*"I find that the failure by GAD, as part of the scrutiny process, to question and seek to resolve questions within the Society's regulatory returns for each year from 1994 to 1996 – related to (i) the valuation rate of interest, (ii) the affordability and sustainability of bonus declarations, (iii) apparently arbitrary changes to the assumed retirement ages, and (iv) the holding of no explicit reserves for the liabilities associated with prospective liabilities for capital gains tax, for pensions mis-selling costs, and for guaranteed annuity rates – constitutes maladministration."*

Again, that finding reflects an earlier finding (Report 1/10/343, page 266) to the effect that the failure identified "fell short of what could reasonably be expected of GAD". The Report contains a more detailed summary of the matters found to constitute maladministration at paragraphs 1/11/56-59 (page 321); and an analysis, at greater length, at paragraphs 1/10/298-326 (pages 261-264).

- 2.5 In relation to (i) the valuation rate of interest and (ii) the affordability and sustainability of bonus declarations, the Ombudsman indicated (Report 1/10/298, page 261) that the maladministration in respect of the 1994-1996 returns consisted, broadly, in the continuation of the failures which she had already identified in respect of the 1990-93 returns. She set out the basis for her other findings – (iii) the apparently arbitrary changes to the assumed retirement ages and (iv) the holding of no explicit reserves for guaranteed annuity rate ("GAR") liabilities – in more detail at, respectively, Report 1/10/305-312 (pages 262-263) and 1/10/323-326 (page 264).
- 2.6 The Government accepted the findings of maladministration in relation to (i) the valuation rate of interest; (ii) the affordability and sustainability of bonus declarations; (iii) the apparently arbitrary changes to assumed retirement ages; and (iv) the holding of no explicit reserves for GAR liabilities: paragraph 4.77 (page 23) of the Response. At paragraphs 4.79-84 (pages 23-24) of the Response the basis for that acceptance was explained:

### ***"Valuation interest rates***

*4.79 As in the case of finding 2, the Government accepts the finding of maladministration in respect of the failure to question and seek to resolve issues relating to Equitable Life's approach to valuation interest rates for the reasons explained in paragraph 4.32.*

### ***Affordability and sustainability of bonuses***

*4.80 The Government accepts the Ombudsman's finding of maladministration in respect of the affordability and sustainability of bonuses for the reasons explained in paragraph 4.33 above.*

### ***Changes to retirement ages***

*4.81 The Government accepts that Equitable Life's changes to retirement ages were significant and therefore should have prompted GAD to ask questions of the Society so that the regulator could be satisfied that the changes were justified. The finding of maladministration in this respect is, therefore, accepted.*

### **Explicit reserves for guaranteed annuity rates**

4.82 *The Government accepts that there was a requirement for Equitable Life to reserve for its GAR liabilities in circumstances in which the GARs were valuable to policyholders (when the current annuity rate fell below the guaranteed annuity rate). Indeed, it is accepted that the prevailing level of interest rates at the end of 1995 was such that the GARs were valuable at that date. A GAR reserve should therefore have been established in the base valuation in the 1995 returns, albeit of a modest amount.*

4.83 *The Government accepts that GAD failed to confirm whether a GAR reserve was established in the 1995 returns and on this basis accepts this part of the finding of maladministration. However, in this respect, it considers that GAD was entitled to place reliance on the Appointed Actuary to provide full and proper disclosure in the returns in accordance with his professional responsibility. The disclosures of its GAR exposure provided by Equitable Life to the regulator in its returns were not such as to provide either GAD or the regulator with a clear understanding of the nature and extent of Equitable Life's GAR policies or the potential liabilities which the Society might face.*

4.84 *The Ombudsman places reliance on the information contained in Schedule 5 of Equitable Life's regulatory returns which made reference to the Society's GAR policies. The Government accepts that Schedule 5, provided to the regulator in 1990, contained information as to the level and extent of the GAR policies. However, at the time of the 1990 returns the GARs were neither valuable nor generally an issue of significance or concern. Given Equitable Life's limited disclosure in the regulatory returns in the years following 1990, there was no good reason in 1995 for GAD to have recourse back to the Schedule 5 statements submitted with the 1990 returns."*

- 2.7 The Government has not accepted the fourth finding of maladministration in so far as it relates to the holding of no explicit reserves for capital gains tax and for pensions mis-selling costs: paragraph 4.78 (page 23) of the Response, together with the explanation at paragraphs 4.85-92 (pages 24-26). I understand that this element of the Government's Response to the Report was not challenged before the Administrative Court.

### **Fifth finding of maladministration: presentation of Equitable Life's two valuations**

- 2.8 The Ombudsman's fifth finding of maladministration is at Report 1/11/84 (page 324):

*"I consider that the failure by GAD (i) to ask for the information GAD needed in respect of the Society's 1995 returns to enable them, as part of the scrutiny process, to be sure that the Society had produced a valuation that was at least as strong as the minimum required by the applicable Regulations, and (ii) to pursue the information before them that the omitted information had led to the users of the returns misconstruing the financial strength of the Society, constitutes maladministration."*

Again, that finding reflects an earlier finding (Report 1/10/396, page 273) to the effect that the failure identified "fell short of what could reasonably be expected of GAD". The Report contains a more detailed summary of the matters found to constitute maladministration at

paragraphs 1/11/61-83 (pages 322-324) and an analysis, at greater length, at paragraphs 1/10/344-395 (pages 266-273).

- 2.9 In its Response the Government accepted that the failure to request the information needed to ensure that, in the 1995 returns, the Society had produced a valuation that was at least as strong as the minimum required by the applicable Regulations – in particular, information as to the resilience reserve figure – constituted maladministration; but rejected the fifth finding of maladministration in all other respects: paragraph 4.115 (page 29) of the Response, together with the explanation at paragraphs 4.117-122 (pages 29-30).
- 2.10 The Court held that it was unlawful for the Government to reject this finding on the basis that it did – paragraphs 103-112 of the Judgment – and the Government has now accepted the whole of the fifth finding of maladministration.

### **The finding of injustice flowing from the second, fourth and fifth findings of maladministration**

- 2.11 The Ombudsman’s specific finding of injustice in relation to the second, fourth and fifth findings of maladministration, taken together, is at Report 1/12/100 (page 346):

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

- 2.12 The Report contains a more detailed summary of the matters found to constitute this injustice at paragraphs 1/12/89-99 (pages 345-46). There are passages identifying the specific consequences of the Ombudsman’s individual findings of maladministration in relation to the second finding at paragraphs 1/12/16-19 (pages 336-337); in relation to the fourth finding at paragraphs 1/12/28-30 (pages 338); and in relation to the fifth finding at paragraphs 1/12/33-37 (pages 338-339). The general consequences of all the Ombudsman’s findings of maladministration taken together are set out at Report 1/12/59-81 (pages 341-344). In its Response, the Government rejected this finding of injustice, in so far as it related to the second finding of maladministration, for the reasons set out at paragraphs 4.34-55 (pages 16-19); in so far as it related to the fourth finding of maladministration, for the reasons set out at paragraphs 4.93-111 (pages 26-28); and in so far as it related to the fifth finding of maladministration, for the reasons set out at paragraphs 4.123-128 (pages 30-31).
- 2.13 The Court held that it was unlawful for the Government to reject these findings of injustice on the basis of the reasons set out in the Response. The Court’s reasons for its decision in relation to the injustice found by the Ombudsman to have resulted from the second and fourth findings of maladministration are set out at paragraphs 71-97 of the Judgment: its reasons in relation to the injustice found to have resulted from the fifth finding of maladministration are set out at paragraphs 103-112 of the Judgment.

### 3 FLEXIBLE OR REPORT-BASED APPROACH?

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#### Nature of the flexible approach

- 3.1 In my First Interim Report, I identified two possible approaches to the assessment of relative loss suffered in respect of accepted cases of maladministration. I referred to these as the “flexible” and the “Report-based” approaches. The difference between them, put shortly, is that:
- (i) The flexible approach would assess the relative loss resulting from the accepted cases of maladministration by reference to the position that policyholders would have been in if, from an appropriate start date, their investments had been made (at the time or times when made) in a comparator (real or notional).<sup>1</sup>
  - (ii) The Report-based approach would assess relative loss by reference only to those paragraphs of the Report which set out specific findings of injustice: that is, paragraphs 1/12/100 (in respect of the second, fourth and fifth findings), 1/12/146 (in respect of the sixth finding) and paragraph 1/12/168 (in respect of the tenth finding). In particular, the Report-based approach would seek to measure relative loss by reference to policyholders’ exercise of the choices available to them at and after the relevant events identified by the Ombudsman: the publication of Equitable Life’s regulatory returns for each of the years 1990-96 (in respect of the second, fourth and fifth findings); the publication on 1 May 1999 of the regulatory returns for the year 1998 (in respect of the sixth finding); and on each relevant occasion when the FSA provided information concerning Equitable Life’s solvency in late 2000 (in respect of the tenth finding).
- 3.2 In my First Interim Report, I commended the flexible approach on the basis that it is “fairer, quicker and more certain”<sup>2</sup> than the Report-based approach. I invited representations on the question whether my Terms of Reference permit me to adopt the flexible approach.
- 3.3 My reasons for considering the flexible approach to be “fairer, quicker and more certain” than the Report-based approach are set out at some length in the First Interim Report. They may be summarised as follows:
- (i) The Report-based approach would exclude loss suffered, as a result of accepted cases of maladministration, by those who could not have relied on the relevant regulatory returns at the time when they made a relevant investment decision: in particular, it would exclude all loss suffered as a result of maladministration by those who took out with-profits annuities (“WPAs”) prior to the date of the first accepted case of maladministration. Further, it would exclude loss suffered as a result of maladministration which occurred after they had made a relevant investment decision by those who, following the decision, had no rights to withdraw funds from the Society: in particular, it would exclude loss suffered, as a result of subsequent

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<sup>1</sup> See paragraph 1.4 of my first Interim Report.

<sup>2</sup> See paragraph 2.42 of my first Interim Report.

maladministration, by those who took out WPAs after July 1991. Exclusion of loss suffered as a result of post-investment maladministration cannot be seen as “fair”.

- (ii) If relative loss were to be assessed by strict reference to policyholders’ reliance on regulatory returns or information provided by the FSA, it would be necessary either (a) to adjudicate all claims individually; or (b) to make a general discount class by class and year by year. The first seems to me to be wholly impractical; for the reasons explained in my First Interim Report. The second, while preferable to an individual assessment, is also unsatisfactory; again for the reasons explained in my First Interim Report.

3.4 Given that my Terms of Reference require me to advise as to:

*“the extent of relative losses suffered by different classes of policyholder in respect of each case of maladministration”*

I must determine whether I am required by those Terms of Reference to have regard only to the specific findings of injustice expressed in the paragraphs of the Report to which I have referred (1/12/100, 1/12/146 and 1/12/168); or whether I am permitted to take account of all financial losses and lost opportunities (in so far as they are the subject of findings by the Ombudsman) which result from the accepted cases of maladministration, including loss suffered by policyholders by reason of accepted cases of maladministration which occurred after they had invested in the Society. If I am required to have regard only to the Ombudsman’s specific findings of injustice, I must conclude that my Terms of Reference do not permit me to adopt the flexible approach.

### **Do my Terms of Reference permit me to adopt the flexible approach?**

- 3.5 At the time the Proposals were issued, I was inclined to the view that my Terms of Reference, read with the terms in which the Ombudsman had expressed her findings of injustice, precluded me from taking any account of loss suffered by policyholders by reason of the fact that, after they had invested, the Society was not properly regulated (referred to in the Proposals as “Head B” losses).
- 3.6 Following my First Interim Report, I was informed by the Ombudsman that her recommendations for redress had not been intended to exclude policyholders who had not relied on the information contained in regulatory returns; but had been intended to cover all those who suffered a relative loss.<sup>3</sup>
- 3.7 The Ombudsman’s statement of her intentions, made after her Report had been published, does not, of course, alter the contents of the Report itself. Nevertheless, it is appropriate that I should have regard to it. In the light of that unequivocal statement, I gave further consideration to the relevant passages of her Report. I set out the results of that consideration in a letter to HM Treasury dated 1 October 2009. In an Annex to that letter I analysed the relevant paragraphs of the Ombudsman’s Report in detail.<sup>4</sup> The principal points made in my letter and its Annex are summarised below:

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<sup>3</sup> See the Ombudsman’s letter to me dated 20 August 2009, at page 39 of the Correspondence.

<sup>4</sup> See the letter at page 11 and the Annex to the letter at page 21 of the Correspondence.

- (i) I explained that, on the one hand, the specific findings of injustice made by the Ombudsman – in paragraphs which appear in her Report in bold type and are plainly intended to be treated as summaries of her findings (1/12/100, 1/12/146 and 1/12/168) – would exclude those who could not have relied on the regulatory returns for the years 1990-96 and who had no right to withdraw funds after 1 May 1999.
- (ii) I pointed out, on the other hand, that it is impossible to avoid the conclusion that some policyholders did, in fact, suffer losses as a result of accepted cases of maladministration although they did not rely on the Society's regulatory returns: in particular, it is impossible to avoid the conclusion that some policyholders suffered loss because the Society was weakened by the fact that it did not take steps that it would have taken had there not been maladministration in its regulation. And it is plain that the Ombudsman recognised that: Report 1/12/67-81 (pages 342-344) and, in particular, 1/12/80 (page 344).
- (iii) I explained that I had found it impossible to identify any rational basis on which the Ombudsman could have reached the conclusion that policyholders who, as she recognised, had suffered loss from the maladministration which she had identified – but who had suffered that loss in circumstances where they had no choice but to remain in Equitable Life – should be excluded from redress. In particular, I had found it impossible to identify any rational basis on which the Ombudsman could have intended to exclude from her recommended scheme elderly annuitants who had taken out WPAs before 1 July 1991 – and who had suffered loss resulting from subsequent maladministration – but who could not have relied on the regulatory returns which she had found to be flawed by reason of that maladministration. Given that, of all the Society's policyholders, elderly annuitants are those who are most likely to be in present hardship and least able to remedy any losses suffered as a result of maladministration (for instance, by postponing retirement or returning to work), I found it impossible to think that that was, indeed, the Ombudsman's intention. At the least, if that had been her intention, she could have been expected to explain why she took that view. As I have said, she has since stated that that was not her intention.
- (iv) I observed that, if the Ombudsman's Report had been written on the basis that it would be construed as a legal instrument (which, plainly, it was not), and if I had been asked to construe it as a lawyer (which is not my task), I would have been very reluctant to reach the conclusion that it must be given an effect which must be seen as irrational. Unless driven to do so, I would not think it right to attribute to its author an intention which seems inexplicable. Given the context in which I had been asked to advise the Government, I was all the more reluctant to proceed on the basis that the Report must be given an effect which it cannot have been intended to have.
- (v) After considering the Ombudsman's findings, I turned to the interpretation of my Terms of Reference. As I have said, I am asked to advise as to:

*“The extent of relative losses suffered by different classes of policyholders in respect of each [accepted case of maladministration resulting in injustice] ...”*

I am not asked, in terms, only to advise as to the extent of relative loss attributable to specific findings of injustice.

- (vi) I pointed out that, in carrying out the task for which I was appointed, I need to have in mind that the context in which my advice has been sought is the Government's intention to "introduce a fair payment scheme for policyholders" (paragraph 5.33 of the Response). As I had observed, at paragraph 2.5(ii) of the First Interim Report, it may be said that a payment scheme would not be fair if it excluded policyholders who can be seen to have suffered (or to be likely to have suffered) losses in respect of the accepted cases of maladministration. It is not, I think, an answer to that point to assert that, on one view of the Ombudsman's Report – a view which could fairly be described as over legalistic – some of those who have, in fact, suffered losses in respect of the accepted cases of maladministration would not have been included in the Ombudsman's proposed compensation scheme. Aside from any other argument, the Government has rejected the Ombudsman's proposed compensation scheme in favour of "a fair payment scheme".
- 3.8 In my letter of 1 October 2009, I explained that, for those reasons, I was persuaded that the effect of the Ombudsman's Report read as a whole is not to exclude those who (at the relevant time) could not have relied on the 1990 to 1996 regulatory returns. At the least, it cannot be said with confidence that the Ombudsman intended to exclude losses suffered by policyholders solely by reason of the fact that, after they had invested, the Society was not properly regulated (Head B losses); and it seems to me that it would be wrong for me to treat my Terms of Reference as requiring me to advise on that basis.
- 3.9 The Court handed down the Judgment shortly after my letter of 1 October 2009. The Judgment could be said to support the approach to interpreting the Ombudsman's Report set out in my letter; in that the Court held (at paragraph 86) that it is necessary to read the Ombudsman's Report as a whole. Individual passages should not be considered in isolation.
- 3.10 The Government addressed some of the issues raised in my letter of 1 October 2009 in a letter dated 27 October 2009 from the Exchequer Secretary to the Treasury.<sup>5</sup> In that letter, the Government indicated that it did not consider the flexible approach to be consistent with the wording of the specific findings in the Ombudsman's Report, and set out some of its reasons. I have given careful consideration to the reasons expressed in that letter; but I am not persuaded by them. I have received from the Ombudsman a further letter, dated 27 November 2009, setting out her views. I have considered the reasoning in that letter and its attachments. It points, broadly, to the conclusion which I had reached: that the Ombudsman did not intend to exclude those who took out policies prior to 1 July 1991.
- 3.11 I am satisfied that I am not precluded by my Terms of Reference from taking account of losses suffered by policyholders solely by reason of the fact that, after they had invested, the Society was not properly regulated (Head B losses). I am satisfied that I am permitted to adopt the flexible approach. That is what I propose to do.

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<sup>5</sup> This letter was sent by the section of the Treasury charged with making representations to me as to the substance of my work, not that section charged with supporting the progress of my work and preparing to deliver the ex-gratia payment scheme.

3.12 I should add that my decision to adopt the flexible approach, although firm, must be regarded as provisional: in the sense that no issue relevant to my advice should be treated as having been finally determined until I deliver my final Report. Further representations (if any) to the effect that I should not adopt the flexible approach will be given the consideration that they merit.

## 4 HOW SHOULD THE FLEXIBLE APPROACH BE PURSUED?

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4.1 At paragraph 2.43 of my First Interim Report, I identified three matters which need to be determined if I am to give effect to the flexible approach. These are, in respect of each policyholder (as determined by, among other matters, the type of policy held and the dates of entry and exit):

- (i) the appropriate start date;
- (ii) the appropriate comparator; and
- (iii) the appropriate end date.

In this Section, I set out my further thoughts on each of these matters.

### Start date

4.2 At paragraph 2.44 of my First Interim Report, I expressed the view that the natural start date for each policyholder is the date on which he first invested in the Society. Broadly, I remain of this view.

4.3 Nevertheless, there is a question as to the treatment of funds which were invested prior to July 1991: that being the date of the first accepted finding of maladministration. At the time of my First Interim Report, I was minded to treat each policyholder who had funds invested at that date as having made an investment in a sum equal to his policy value at that date. But I am aware of a widely held view that the Society had declared excessive bonuses during the 1980s, and possibly earlier.<sup>6</sup> At paragraph 11 of the Judgment the Court observed that “During the 1980s and 1990s, Equitable declared bonuses which were very high relative to its profits and assets”. It has been suggested that, to the extent that this occurred, I should attempt to take these excessive bonuses into account. It is said that it would be appropriate as a matter of fairness for those who benefited from excessive bonuses in the 1980s or earlier to bring them into account before receiving any money from the Government. These suggestions have some force.

4.4 On the other hand I am concerned at the practical difficulty of determining whether any individual policyholder did, in fact, receive excessive bonuses prior to 1990. In this regard, I have in mind two matters in particular:

- (i) As I pointed out at paragraph 2.44 of the First Interim Report, reliable individual data concerning Equitable Life’s policyholders is not readily available in electronic form (or at all) for the period prior to the end of 1992.<sup>7</sup> In some cases (for example, with-profits annuitants) it is possible to derive earlier data from what currently exists. However, in most instances it is not possible to do so reliably.

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<sup>6</sup> See, for example, paragraphs 19/40-49 (pages 689-690), and particularly paragraph 19/40 (page 689), of the Penrose Report.

<sup>7</sup> It may well be that Equitable Life itself has older data stored in hard copies. However, to process that data would require disproportionate time and expense. In relation to group and overseas policyholders reliable electronic data is not available prior to, respectively, the end of 1994 and the end of 1997.

- (ii) Although there is material to suggest that excessive bonuses were declared during the 1980s, I find it difficult to see how this could be determined as a fact on the basis of the information available to me.
- 4.5 In light of the above, if were to make a deduction in respect of funds already invested by July 1991 (as to which I have not yet made a decision), I am minded to do so by a general deduction applied to all funds held at that date in recognition of the extent to which policy values at that date exceeded the value of the Society's assets.
- 4.6 I invite comment on these matters.

## Comparator

- 4.7 The "flexible approach" which I indicated in my First Interim Report that I was minded to adopt is intended to measure losses of two different kinds (to which I referred in my Proposals as "Head A" and "Head B" losses). Put shortly, Head A losses are losses suffered as a result of a policyholder making an investment decision which, but for maladministration, he would not have made: Head B losses are losses suffered as a result of being a policyholder in Equitable Life at a time when, by reason of maladministration, the Society was not being regulated as it should have been. In setting out the approach that I currently intend to take in identifying an appropriate comparator, it is necessary, first, to consider Head A and Head B losses separately.
- 4.8 As I indicated in the First Interim Report, I take the view that it would be unrealistic to expect individual policyholders to be in a position to establish that, but for accepted maladministration, they would not have made the investment decisions that they did make; and impracticable and unfair to require them to do so. It follows that, if I were seeking only to measure Head A Loss, it would be necessary to find some way of giving effect to the principle that participation in the scheme depends upon reliance on regulatory returns: but without requiring individual policyholders to demonstrate that, but for accepted maladministration, they would not have made the investment decisions that they did.
- 4.9 A possible approach would be to discount all Head A loss resulting from investment decisions made in a given year by an appropriate percentage to reflect the possibility that individual policyholders might have made the same decisions in any event: that is to say, absent maladministration. In that context, I recognise that there may well be force in the point that no discount should be applied to Head A loss resulting from investment decisions made after 1 May 1999, by virtue of the manner in which the Ombudsman expressed her sixth finding of injustice at paragraph 1/12/146 (page 351).
- 4.10 In her letter of 20 August 2009 the Ombudsman expressed the view, which she developed in her subsequent letter of 27 November 2009, that (absent maladministration) no reasonable person would have invested in the Society after July 1991 or remained invested after that date. I cannot find that view expressed, in those terms, in the Report. In so far as the Ombudsman has expressed a view which was not set out in the Report, I do not consider myself to be bound by that view; and I am not minded to accept it without further analysis.

- 4.11 If I were seeking only to measure Head A loss, there would be obvious force in the proposition that, in selecting an appropriate comparator (or comparators), I should begin by identifying life offices that policyholders would have chosen as an alternative to Equitable Life. It may be that the choice of an alternative life office would differ from year to year and would differ according to the investment product.
- 4.12 That proposition has much less force, as it seems to me, if I am also seeking to measure Head B loss. That is because, on a true analysis, the relative loss suffered by a policyholder who would not (or could not) have made a different investment decision (absent maladministration) does not fall to be measured by reference to the position in which he would have been if he had invested elsewhere: his relative loss is to be measured by reference to the position in which he would have been if Equitable Life had been properly regulated. That is what he was entitled to expect: given the premise that he would not, or could not, have chosen to invest elsewhere. The true comparator (in the context of Head B loss) is Equitable Life as it would have been had the accepted maladministration not occurred.
- 4.13 In the context of Head B loss, the relevant question, as it seems to me, is whether I should attempt (with the assistance of my actuarial advisers) to construct a notional comparator based on assumptions as to how the business of Equitable Life would have been conducted had maladministration not occurred; or whether I should seek to identify a life office (or life offices) having the same or similar characteristics to Equitable Life and use the performance of that office, or offices, as the basis for a comparator. In each case, there are obvious difficulties.
- 4.14 As I have said, the flexible approach is not intended to measure only Head A Loss: it is intended to measure both Head A and Head B Loss. If I adopt that approach, the question of reliance becomes significantly less important. That is because a policyholder who could not establish that, but for accepted maladministration, he would not have made an investment decision that he did make (the pre-condition for Head A Loss) can, nevertheless, claim to have suffered Head B Loss as a result of that investment decision. If both Head A Loss and Head B loss are measured by reference to the same comparator, it becomes irrelevant whether (absent maladministration) the policyholder would or would not have made that investment decision. And, there is no need to consider discounting.
- 4.15 My present view is that I should seek a comparator which, consistently with the considerations which I have described, can properly be used to measure both Head A and Head B loss. I currently consider that it may be possible to achieve this by using a number of different comparator companies, weighted appropriately.
- 4.16 The weighting given to each comparator company would vary over time, so as to reflect two matters (among others): first, the nature of the Ombudsman's findings; and, second, the fact that the positions and characteristics of the other life offices would have changed during the 1990s.

## **End date**

- 4.17 At paragraphs 2.47 and 2.48 of my First Interim Report, I set out my views, as they stood at that time, as to the appropriate end date. Since the publication of my First Interim Report, I

have received comments and representations which have caused me to re-consider the matters addressed there. In the paragraphs below, I set out what I currently consider to be the principal considerations relevant to the setting of an end date for (i) those who hold policies other than WPAs; and (ii) those who hold WPAs.

### *Holders of policies other than WPAs*

4.18 At paragraph 2.47(i) of my First Interim Report, I put forward the view that 30 June 2008 would represent the appropriate end date for the bulk of policyholders, on the basis: (a) that it was the nearest half-year end to the date on which the Ombudsman published her Report; and (b) that it represented a something of a mid-point in recent market fluctuations.

4.19 Since that date, I have received representations to the effect that it would be appropriate to pick a much earlier date: a date which fell shortly after Equitable Life closed to new business on 8 December 2000. The following dates have been suggested:

- (i) July 2001, immediately after the Society imposed cuts of approximately 14% and 16% on life and pensions policies respectively; or
- (ii) March 2002, immediately after the compromise scheme pursuant to Section 425 of the Companies Act 1985 was approved by the High Court.

In my view, the rationale behind these proposals is that it could be said that, if, by these dates, there was still incorrect information about Equitable Life's finances in the public domain (as to which I express no view), that was not the result of the maladministration found by the Ombudsman. From that point, it might be said, policyholders had the choice whether to remain in or leave Equitable Life; and they should be fixed with the consequences of that choice.

4.20 Before considering the merits of these suggestions, it is important to keep in mind that, if a date shortly after the Society closed to new business were chosen, it would be necessary:

- (i) to calculate relative loss with reference to the amount that could actually have been withdrawn from Equitable Life at that time after any market value adjustment had been applied and not simply by reference to the amount shown as the policy value at that time; and
- (ii) to add interest to any loss so calculated, to reflect the passage of time since the funds could have been so withdrawn.

Keeping those points in mind, I see the force of the argument set out above in favour of an early end date.

4.21 Against that, I see the force in the counter-argument that the decision whether or not to withdraw funds in 2001 or 2002 was a difficult one for policyholders: and one which, it might be argued, would not have confronted them at all if there had been no maladministration. In all the circumstances, it may be said, it is appropriate to measure loss with reference to what has actually occurred since the Society closed to new business.

4.22 I have not yet reached a view on this issue, and I invite representations and comment.

## *Holders of WPAs*

4.23 I am satisfied that the arguments canvassed in the preceding paragraphs have no application to holders of WPAs: once a person had purchased a WPA, he had no opportunity to make any withdrawal from Equitable Life. In respect of WPA policyholders, I currently propose to follow the approach set out at paragraph 2.47(iv) of my First Interim Report; and to treat 31 December 2007 as the end date. But comments that I have received in relation to that paragraph suggest that there may be some misunderstanding among policyholders as to what was intended. Some further explanation may be of assistance.

4.24 Potentially, policyholders who took out WPAs may have suffered both loss of past income and the anticipated loss of future income. It seems to me that, in principle, both past and anticipated future loss of income should be taken into account in any fair payment scheme. An end date of 31 December 2007 would allow this to be done. The computation of loss would require two steps:

- (i) First, to determine the difference between the amount the policyholder received by way of annuity payments up to 31 December 2007 and the amount that he would have received if he had invested in the comparator.
- (ii) Second, to determine the difference between the notional value of the WPA policy as at 31 December 2007 and the notional value that the policy would have had if it had originally been invested in the comparator.

4.25 The approach which I have suggested in the preceding paragraph would pose a number of further problems of detail, which I am currently considering with my advisers. Those problems include:

- (i) how to conduct any off-setting in those cases where the computation under sub-paragraph (i) of the previous paragraph would show that the policyholder had experienced a relative gain but the computation under sub-paragraph (ii) showed a relative loss;
- (ii) how to account to the estates of those policyholders who have died since 31 December 2007;
- (iii) how to take into account tax on the income that the policyholder would have received if there had been no maladministration;
- (iv) how (if at all) to account for offsetting across single- and joint-life policies; and
- (v) what allowance (if any) to make for payments that policyholders may have received in respect of claims brought or intimated against Equitable Life.

It is likely that similar problems will arise in relation to holders of other types of policy.

4.26 I welcome any representations or comments on these matters.

## 5 NATURE AND EXTENT OF THE SECOND, FOURTH AND FIFTH FINDINGS

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5.1 My Revised Terms of Reference require me to advise as to

*“the nature and extent of the finding of maladministration and injustice in relation to Finding 5 and the nature and extent of the finding of injustice in relation to Findings 2 & 4 so far as those Findings are now accepted.”*

5.2 My present view is that adopting the flexible approach will avoid the need for an exhaustive inquiry into the extent of the Ombudsman’s specific findings of injustice in relation to the second, fourth and fifth findings of maladministration. It will be enough to identify the consequences of the maladministration which is the subject of those findings: and to decide whether the Ombudsman has found that those consequences gave rise to financial loss or lost opportunities. Nevertheless, my advice has been sought in specific terms; and it is appropriate that I should explain what I understand the scope of what I am required to do under this new head.

5.3 I have found it convenient to approach the issue on which I have been asked to advise in the sequence in which it is presented: first, by considering maladministration and injustice in relation to the fifth finding; and then by considering injustice pursuant to the second and fourth findings.

### **Maladministration and injustice in relation to the fifth finding**

5.4 This finding arises in the statutory and administrative context which the Ombudsman has summarised at Report 1/10/362-366 (pages 268-269). In those paragraphs, she explained that regulations 55 to 64 of the Insurance Companies Regulations 1981 (the “Regulations”) set out an approach to valuing the Mathematical Reserves to be reported by an insurance company in its regulatory returns.

5.5 Most insurance companies at the time in question used the method set out in the Regulations, but they were not required to do so. If an insurance company used a different method, it was required to demonstrate that the Mathematical Reserves which it reported were at least as high as those which would have been generated by the valuation method and minimum basis set out in the Regulations: Report 1/10/344 (page 266).

5.6 Throughout the period in question, Equitable Life used a valuation method which differed from that set out in the Regulations. This was the valuation method used in the main body of its regulatory returns: the Ombudsman has referred to it in the Report as the “main valuation”.

5.7 In order to demonstrate that the main valuation generated liabilities that were at least as high as those which would have been shown by a valuation carried out according to the method set out in the Regulations, Equitable Life set out information about its Mathematical Reserves calculated on a basis that its Appointed Actuary considered to be consistent with the Regulations in an appendix at the end of Schedule 4 of its returns. The Ombudsman referred

to this valuation as the “appendix valuation”: see, for example, the Glossary at page xxii of Part One of the Report.

- 5.8 However, Equitable Life did not provide full information about the appendix valuation in its returns. In particular, it omitted the amount of the resilience reserves which would be required under the valuation method set out in the Regulations: Report 1/10/348 (page 267).
- 5.9 Within this context, the fifth finding of maladministration (Report, 1/11/84, page 324, set out in the preceding section at paragraph 2.8) comprised two elements. The first was GAD’s failure to ask for the information it needed in respect of the Society’s 1995 returns in order, as part of the scrutiny process, to satisfy itself that the Society had produced a valuation that was at least as strong as the minimum required by the applicable Regulations. The substance of this element of the finding was that, in scrutinising the 1995 returns, GAD should have asked, but did not ask, to see the Society’s calculation of its resilience reserves: Report 1/10/351 (page 267); 1/10/368-373 (pages 269-270); and 1/10/388-391 (page 272).
- 5.10 I can find nothing in the Report to suggest that the Ombudsman made a finding to the effect that, if GAD had asked to see the Society’s calculation of its resilience reserves, the figures provided would have caused GAD (or the regulator) to require any modification of the 1995 regulatory returns. I am advised that it is unlikely, now and in the absence of working papers relating to the period in question, to be possible to say with confidence what the result of the Society’s resilience reserves calculations would have been. And, in that context, it must be kept in mind that, in earlier years, the Society had demonstrated to GAD through the scrutiny process that its Mathematical Reserves were at least as high as those which would have been shown by a valuation in accordance with the applicable Regulations.
- 5.11 If it is not possible to answer with certainty the question what would have happened if the accepted maladministration had not occurred, it seems to me that I can only quantify the maladministration (which is what I understand I am asked to do by the requirement that I advise as to its *extent*) on the basis of probability. That is, I must seek to answer the question, by reference to whatever information is available, how likely is it that the Society’s resilience reserve calculations would have shown that the 1995 regulatory returns required a material amendment; and, if so, how great would that amendment have been.
- 5.12 The second element in the fifth finding was GAD’s

*“failure . . . to pursue the information before [it] that omitted information had led to the users of the returns misconstruing the financial strength of the Society.”*  
(Report 1/11/84 at page 324)

The information which GAD should have pursued was information that Standard & Poor’s had produced ratings for the Society which were founded on the incorrect belief that the Society employed a conservative valuation methodology. The reason that Standard & Poor’s had formed this incorrect belief was that the Society’s calculation of its resilience reserves had been omitted from its regulatory returns: Report 1/10/358-359 (page 268); 1/10/374-377 (page 270); and 1/10/392-394 (pages 272-273).

- 5.13 The finding, as I understand it, was not that GAD should (or could) have procured any change to Standard & Poor’s rating. Rather, the finding was that, in circumstances where GAD knew the rating to be based on a misunderstanding of the Society’s regulatory returns, GAD should

not have allowed the rating to be used as a basis for administrative decisions; and should have taken such action as was possible in relation to the presentation of the regulatory returns themselves.

- 5.14 In considering the *extent* of this finding of maladministration, it seems to me that I must start from the position that, as the Ombudsman acknowledged, GAD had no power to require the Society to set out its resilience reserves in its regulatory returns: see Report 1/10/369-370 (pages 269-270) and 1/10/395 (page 273). And, I should also have regard to Report 1/10/393 (page 273); where the Ombudsman criticised GAD for allowing Standard & Poor's flawed rating to be used, among other matters:

*"in scrutiny reports, as briefing for Ministers and to deal with enquiries as to the strength of the Society."*

- 5.15 Of these matters, the use of the flawed ratings in scrutiny reports is likely to have had its primary impact on policyholders through subsequent regulatory returns in response to which the scrutiny reports were produced. The use of unreliable material to brief ministers is likely to have had only an indirect impact on policyholders: it could be, for example, that if ministers had not been informed that the Society's financial position was strong, they might have directed the prudential regulators to watch it more closely. This could have resulted in regulatory intervention into the management of Equitable Life being made earlier than it in fact was. The use of unreliable information to deal with enquiries as to the strength of the Society is likely to have had an adverse effect on those who made the enquiries in question. It may also be, however, that they, in turn, disseminated unreliable information to others, so that GAD's maladministration in this regard had a wider effect.

- 5.16 In addressing the nature and extent of the injustice resulting from these findings, it is appropriate to start with the specific finding at Report 1/12/100 (page 346), set out at paragraph 2.11 of this Second Interim Report. In light of the fact that it is unlikely to be possible to say with any certainty whether the regulatory returns would, in fact, have been different if there had been no maladministration under this head – or, if they had differed, how they would have differed – it seems to me that I must, again, adopt an approach based on probability: both as to whether changes would have been made and, if changes had been made, how significant they would have been.

- 5.17 In addition to the specific finding of injustice (Report 1/12/100, page 346) I must also consider to what extent the Ombudsman's findings as to the more general consequences of maladministration may be said to have flowed from the fifth finding of maladministration. In this regard, it seems to me that the critical paragraphs are Report 1/12/67-70 (pages 342-343). It may be that, if the prudential regulators, and ministers briefed by them, had at all times borne in mind GAD's knowledge as to the unreliability of the ratings produced by Standard & Poor's, they would have taken earlier action; and that such action might (but not necessarily) have left the Society's policyholders in a better financial position than they are now. But, it may be that the general consequences identified at Report 1/12/71-80 (pages 343-344) are also relevant. In particular, it may be that if the regulators had at all times borne in mind what they knew to be the true extent of the weakness of the Society's financial position, they might have given more active consideration to the possibility of an earlier exercise of their full range of regulatory powers.

## Injustice under the second and fourth findings

- 5.18 The specific injustice which the Ombudsman found to have resulted from the second and fourth findings of maladministration was also identified at Report 1/12/100 (page 346). Given the terms in which that paragraph has been expressed, it may be thought that the nature and extent of the injustice resulting from the second and fourth findings of maladministration should be measured primarily against policyholders' reliance on the relevant regulatory returns. On this basis, the principal question to be addressed would be how the contents of the regulatory returns would have differed had there been no such maladministration.
- 5.19 However, for the reasons that I have explained above, I do not consider that this is the only effect of the second and fourth findings of maladministration, or even the principal one. Therefore, in respect of each element of these findings, it is important to look not only at their effect on Equitable Life's regulatory returns, but also at their broader consequences.
- 5.20 As set out at Report 1/11/40 (page 319) of the Report, there were two elements in the second finding of maladministration. These same two elements were present in the fourth finding; but, in relation to that finding, the Ombudsman found two further elements: Report 1/11/60 (page 321). In the present context, it is convenient to consider those four elements separately.

### *(i) Valuation rate of interest*

- 5.21 The Ombudsman found that there was maladministration relating to the valuation rate of interest in both the regulatory returns for 1990 to 1993 (the second finding) and the regulatory returns for 1994 to 1996 (the fourth finding): that is to say, the Ombudsman found that the rate at which the Society discounted its long-term liabilities for the purposes of calculating its reserves in those returns was, or may have been, too high.
- 5.22 I find nothing in the Report to suggest that the Ombudsman made any finding that the valuation rate of interest used by the Society was, in fact, imprudent and/or impermissible: rather, she found that it appeared to be so, and that GAD should have sought to resolve that issue: Report 1/10/135 (page 239).
- 5.23 It is my present understanding, from actuarial advice, that there is no single correct answer to the question what valuation rate of interest should have been used at that time in estimating a life insurance company's future liabilities. Rather, there was a range of possible rates which could have been adopted in relation to different categories of liability; and the rate to be adopted would vary according to a range of different factors, including yield on assets backing liabilities, bonus expectations and the duration and nature of the liabilities. Nonetheless, in any given case, there is likely to be a consensus among actuaries as to the range within which any particular rate should fall. The consensus would be, I am informed, that the bare minimum figure allowable under the regulations would not have fallen within this reasonable range in respect of the with-profits business.
- 5.24 It seems to me that in fulfilling the requirement in my Terms of Reference that I should advise on the nature and extent of the injustice resulting from this element in the second and fourth findings of maladministration, I should first seek to identify the range within which the Society might reasonably have selected its valuation rate of interest. I shall then need to determine

what figure within that range GAD should and could reasonably have required the Society to select. My present view is that in identifying that figure, I should recognise that Equitable Life is likely to have resisted the attempt to force it to adopt figures at the most prudent end of the range: rather, the figure chosen would be likely to have fallen towards, though not necessarily at, the less prudent end of the range of reasonable answers.

**(ii) Affordability and sustainability of bonuses**

- 5.25 The Ombudsman found that there was maladministration relating to the affordability and sustainability of bonuses in both the regulatory returns for 1990 to 1993 (the second finding) and 1994 to 1996 (the fourth finding).
- 5.26 In the context of Equitable Life's regulatory returns, my present view is that this finding should be understood primarily as a finding concerning the bonus rates on which the figures that appeared in Equitable Life's regulatory returns were based. If the Ombudsman had intended to make a finding that GAD had failed to exercise direct pressure on Equitable Life to reduce its bonuses, she would not have found that the resulting injustice had been suffered primarily by those who relied on the regulatory returns.
- 5.27 Once again, I understand that there is no single correct answer to the question what future bonus rates Equitable Life should have assumed for the purpose of its regulatory returns; nevertheless, it is possible to identify the range of figures for bonus assumptions which reasonable actuaries would have regarded as appropriate at the time in question. Once again, I consider that it would be appropriate to recognise Equitable Life's likely reaction to any objection by GAD, the figure eventually chosen would be likely to have fallen towards the less prudent end of the range of reasonable answers.

**(iii) Changes to assumed retirement ages**

- 5.28 The Ombudsman found that apparently arbitrary changes had been made to Equitable Life's retirement age assumptions in both the 1994 and the 1996 regulatory returns (the fourth finding). I addressed this finding at paragraphs 2.2 to 2.7 of the Proposals.
- 5.29 In one sense, this element of the fourth finding raises issues similar to those raised by the valuation rate of interest: in that the Ombudsman's findings were as to the *appearance* of the figures used by the Society. That is, she found that the changes to the assumed retirement ages *appeared* arbitrary: not that, necessarily, the changes *were* arbitrary. But, it seems to me that in relation to this element it is possible, at least in principle, to answer the question whether the changes to retirement age assumptions were *in fact* arbitrary: that is, whether the Society had a justifiable basis for making the changes that it did.
- 5.30 I have begun to investigate this question, and have been provided with information which would suggest that the Appointed Actuary would have sought to justify the changes to the retirement age assumptions had they been challenged by GAD. I am continuing my consideration of the question whether, if GAD had pursued the enquiry that it should have made, it would have been likely to have been satisfied by the representations that it would have received from the Appointed Actuary.

5.31 If I reach the conclusion that GAD would not have regarded Equitable Life's reasons for the change as justifiable, I shall need to consider what other retirement age assumptions GAD could and should have persuaded Equitable Life to adopt. My present view is that it would be appropriate to approach this question in a similar way to those relating to valuation rates of interest and bonus assumptions as set out above.

**(iv) Reserves for GAR liabilities**

5.32 The fourth element in the fourth finding was that GAD should have required the Society to include reserves for GAR liabilities in its regulatory returns for 1995 and 1996.

5.33 Once again, I understand that it is possible to identify the range of figures for reserves in respect of GAR liabilities which reasonable actuaries would have regarded as appropriate at the time in question. And, again, I consider that it would be appropriate to recognise Equitable Life's likely reaction to any objection by GAD: the figure eventually chosen would be likely to have fallen towards the less prudent end of the range of reasonable answers.

**Conclusion in relation to the second and fourth findings**

5.34 The preceding paragraphs are addressed to the effects of the individual elements in the second and fourth findings on the Society's regulatory returns. Further investigation of the effects of those individual elements would form the basis for a conclusion as to what the regulatory returns would have been likely to show, absent maladministration.

5.35 But, as I have pointed out at paragraph 5.2 of this Section, in the context of addressing the nature and extent of the injustice resulting from the fifth finding of maladministration, it may be sufficient to consider only the broader question whether the Ombudsman has found that those consequences gave rise to financial loss or lost opportunities.

5.36 Again, as with the fifth finding, I should bear in mind that the second and fourth findings related not only to the contents of the regulatory returns: they had a bearing on the general consequences of the maladministration identified at Report 1/12/59-80 (pages 342-344). I consider that, of those general consequences identified by the Ombudsman, that most likely to have caused loss to policyholders (in relation to the second and fourth findings) was the loss of opportunities to address issues earlier: Report 1/12/67-70 (pages 341-343). However, it may also be the case that, had the relevant instances of maladministration not occurred, the prudential regulators would also have been more alert to the other powers that they could have exercised: (Report 1/12/71-80 (pages 343-344).

## 6 QUESTIONS TO BE ADDRESSED

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- 6.1 In this Section, I set out (in the form of a list) the questions which I currently consider I shall need to address. I invite comment as to whether these are the correct questions; and I invite representations as to how they should be answered.

### Nature and extent of the Ombudsman's findings

#### *Second finding*

- 6.2 What would have been the effect on Equitable Life's regulatory returns for the years 1990 to 1993 if GAD had taken the action which it should have taken in relation to (i) the valuation rate of interest; and (ii) the affordability and sustainability of Equitable Life's bonus declarations?
- 6.3 In relation to the second finding, if the requisite action had been taken, how likely is it that policyholders or prospective policyholders would have decided not to take out new policies or to pay money into existing policies; and when would policyholders have taken such decisions?

#### *Fourth finding*

- 6.4 What would have been the effect on Equitable Life's regulatory returns for the years 1994 to 1996 if GAD had taken the action which it should have taken in relation to:
- (i) the valuation rate of interest;
  - (ii) the affordability and sustainability of Equitable Life's bonus declarations;
  - (iii) the changes to retirement ages which Equitable Life made in respect of its 1994 and 1996 regulatory returns; and
  - (iv) reserves in respect of liabilities for GARs?

*In order to address (iii), I must first determine whether, if GAD had asked questions, it would have received answers that indicated the necessity of any change at all.*

*I have conducted preliminary investigations into this issue, which suggest that the contemporaneous documents which could provide a definitive answer may not be readily available.*

*I have also been informed as to what was considered by Equitable Life's actuaries to be the justification for the change:*

- (1) *At the institution of the personal pension contract in 1988 (which replaced the retirement annuity contract, under which the minimum retirement age had been 60), Equitable Life proceeded on the most conservative assumption, which was that all policyholders would retire at the earliest age possible, namely 50.*
- (2) *By 1994, Equitable Life's experience of policyholders' behaviour was growing and it was becoming clear that holders of personal pension contracts were not retiring at significantly earlier ages than holders of retirement annuity contracts had*

*done. The average retirement age for holders of retirement annuity contracts had been around 65; and Equitable Life had assumed for the purposes of its reserves that all would retire at the age of 60.*

- (3) Equitable Life's experience led it to believe that it would be reasonable to assume a retirement age of 60 in relation to personal pension contracts, as had been done in relation to retirement annuity contracts. However, out of caution and a desire not to make too large a change at once, Equitable Life initially adopted a retirement age of 55 for the 1994 returns.*
- (4) In 1996, after two more years' experience, it was considered that the pattern observed in 1994 had been sufficiently strong that the retirement age assumption should be moved to 60, as could have been justified in 1994.*

*The view has been expressed to me that if this explanation had been put forward to GAD at the relevant time, it would have been accepted as not constituting an arbitrary change to the assumptions on which the regulatory returns were based.*

*I shall need to conduct further investigation before reaching a conclusion as to whether or not this view can be accepted. However, if I were to reach the conclusion that the view can be accepted, I would be likely to conclude that the maladministration consisting in failure to raise questions concerning Equitable Life's retirement ages did not have any consequences for the contents of Equitable Life's regulatory returns for the years 1994-1996.*

- 6.5 In relation to the fourth finding, if the requisite action had been taken, how likely is it that policyholders or prospective policyholders would have decided not to take out new policies or to pay money into existing policies; and when would policyholders have taken such decisions?

#### **Fifth finding**

- 6.6 What would have been the effect on Equitable Life's regulatory returns if GAD had taken the action which it should have taken in relation to (i) the resilience reserve calculations in relation to the 1995 regulatory returns; and (ii) the information that users of Equitable Life's regulatory returns were being misled?
- 6.7 In relation to the fifth finding, if the requisite action had been taken, how likely is it that policyholders or prospective policyholders would have decided not to take out new policies or to pay money into existing policies; and when would policyholders have taken such decisions?

#### **Start date**

- 6.8 In respect of each relevant type of policyholder, by reference to what start date should relative losses be assessed?
- 6.9 What account (if any) should be taken of the possibility that policyholders may have received excessive bonuses prior to the start date?

## Comparator

- 6.10 Is it appropriate to measure relative loss against a single, real comparator or against a notional comparator, based on the performance of Equitable Life's competitors during the period in question?
- 6.11 If a real comparator, what is the appropriate comparator in relation to:
- (i) each type of policy; and
  - (ii) each year of entry?
- 6.12 If the comparator is to be a notional comparator, constructed by reference to Equitable Life's competitors, by reference to what characteristics should those comparators be chosen and what would be the appropriate mix and weighting in relation to:
- (i) each type of policy; and
  - (ii) each year of entry?

*My present view is that the following characteristics are likely to be relevant:*

- (1) mutuality;*
- (2) history of bonus declarations;*
- (3) bonus policy (including whether a policy "full distribution" was operated);*
- (4) length of establishment of the company;*
- (5) financial position at the relevant time;*
- (6) financial position as stated in regulatory returns;*
- (7) range of products offered;*
- (8) advertised business approaches (such as selling directly rather than through intermediaries);*
- (9) target market and customer base;*
- (10) business model, and especially the extent to which it targeted and experienced new business growth; and/or*
- (11) other characteristics.*

## End date

- 6.13 By reference to what end date should relative losses be assessed? Should different end dates be adopted for different types of policies?
- 6.14 What special provision, if any, should be made in respect of the following classes of policyholders:
- (i) policyholders who have died;
  - (ii) policyholders who have surrendered (or made partial withdrawals from) a policy;

- (iii) policyholders whose policy has been transferred to another life assurance or pensions provider;
  - (iv) policyholders who have policies under group schemes; and
  - (v) holders of true regular premium policies?
- 6.15 What subsequent steps taken by policyholders should be taken into account in assessing relative losses? In particular, should regard be had to:
- (i) the surrender of an Equitable Life policy and withdrawal of a fund with penalties;
  - (ii) the transfer of a fund from Equitable Life to another life assurance or pensions provider; and
  - (iii) the conversion of an Equitable Life policy fund into an Equitable Life WPA?

### **Other matters**

- 6.16 To what extent should relative losses be netted off against relative gains (if any) that have accrued? If gains should be netted off against losses, should that extend to gains and losses accrued in respect of different policies held by the same policyholder? How should the following cases be dealt with:
- (i) with-profits annuitants who experienced relative gains in the early years of their policies but are facing reduced incomes in the future as a result of maladministration; and
  - (ii) with-profits annuitants who have experienced a relative gain on a joint-life policy and a relative loss on a single-life policy or vice versa?

Are there other cases of this kind which merit specific consideration?

- 6.17 What account should be taken of tax on income that would have been received if there had been no maladministration?
- 6.18 How should double counting in the assessment of relative loss be avoided? In particular, what account (if any) should be taken of payments that policyholders may have received from Equitable Life in settlement of claims or intimated claims in respect of mis-selling or otherwise?
- 6.19 What special provision, if any, should be taken in relation to those who took out policies with Equitable Life's overseas offices?
- 6.20 How far, consistent with fairness, can the calculation of relative loss be simplified with a view to expediting payments?

## 7 APPORTIONMENT

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7.1 At paragraphs 3.1 to 3.22 of my First Interim Report, I set out my thoughts on the question of apportionment of relative losses as between the public bodies and others. In particular, at paragraphs 3.11 and 3.12, I identified the principles by which, as I then thought, I should be guided in determining the nature and extent of any such apportionment. I have given further thought to those principles.

7.2 At paragraph 3.11(iii) of my First Interim Report, I observed:

*“The purpose of regulation was to serve as a check upon the actions of Equitable Life (including its directors and Appointed Actuary): that is, (a) to ensure that certain information concerning Equitable Life’s financial position that was in the public domain was reliable and (b) to prevent policyholders suffering loss as a result of certain improvident actions by the Society and its officers. Therefore, losses of the kind that have been found by the Ombudsman could be said to be losses of the very kind that the system of regulation was in place to prevent. This, it seems to me, is the primary principle that I should have in mind in considering whether or not notionally to apportion some of the losses experienced to the Society itself.”*

7.3 Nonetheless, there is, as it seems to me, an argument that I should have in mind, also, that a relatively low threshold test for maladministration was adopted by the Ombudsman. The Court accepted the submission that:

*“[The Ombudsman’s] view of the requirements of good administration was thus broader than that of strict compliance with the regulations, or with any specific legal duties of the regulator.”<sup>8</sup>*

7.4 It is one thing to say that, where the regulator has negligently allowed a regulation to be breached, there should be no apportionment against the entity being regulated. But, in circumstances where the criticism of the regulator is made without any finding that a breach of a regulation has occurred, then serious consideration must be given to whether it would be appropriate for the public purse to make good the whole of policyholders’ relative losses. In particular, if it can be said that policyholders’ losses were caused in part by improvident – if not necessarily wrongful – management of Equitable Life’s business, then I can see a case for reducing the extent to which those losses should be borne by the public purse.

7.5 I invite representations on that point. I invite comment, also, on the question whether the newly accepted findings themselves give rise to any other case for apportionment. My current view is that they do not do so.

7.6 I am still considering the specific cases that I identified in the First Interim Report. In particular:

- (i) I have not yet reached a firm conclusion on the question whether the non-disclosure of the letter to which I referred in paragraph 3.13 of the First Interim Report should lead to an apportionment of relative losses resulting from the Ombudsman’s sixth finding of

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<sup>8</sup> See paragraphs 111-112 of the Judgment.

maladministration (which relates to the treatment of the reinsurance treaty in the Society's 1998 regulatory returns); and

- (ii) I understand that Ernst & Young's appeal against findings made under the Joint Disciplinary Scheme has been heard; but that a decision has not yet been handed down. Until that decision is known – or I receive further information which enables me to take the view that it will be of no relevance to my work – I cannot reach a conclusion on the question raised in paragraph 3.20 of the First Interim Report.