

Chapter Four

Description of the prudential regulation of Equitable Life

Part 1

The Inheritance Period

4.1 Introduction

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

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

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

- 4.2.2 In December 1993 the Board of Equitable Life recognised the potential liability arising as a result of current annuity rates falling below GARs. Accordingly, the Board resolved to adopt a practice of making a different terminal bonus award to each policyholder depending on whether the policyholder elected to take:
- (a) an annuity at the GAR set out in the contract; or
 - (b) an alternative benefit (such as an annuity at the current annuity rate from Equitable Life or from another provider).

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

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

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

4.3.2 The report noted that:

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

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

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

4.3.5 Among other matters, the scrutiny report noted that:

- (a) Equitable Life was determined to provide fair bonuses to policyholders, “with no deliberate holding back of profits from one generation to another”;
- (b) Equitable Life had applied for a Section 68 Order for a future profits implicit item each year but used this order for the first time in 1994; the current Section 68 Order for the year ending 31 December 1996 was for £600million, of which about 50% had been used;

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

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

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

- (c) in 1997 the Society had taken a subordinated loan for £350million from a specially created subsidiary, which had floated corresponding bonds on the market; and
- (d) it seemed likely that the current asset shares exceeded the admissible assets.

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

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

4.3.7 The Appointed Actuary also said:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

4.5 Survey by the Faculty and Institute - 1997

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

4.6 Disclosure by Equitable Life of its terminal bonus practice

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

“Where benefits are taken in annuity form and the contract guarantees minimum rates for annuity purchase, the amount of final bonus payable is reduced by the amount, if any, necessary such that the annuity secured by applying the appropriate

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

⁶ Reference is made to this survey in **Chapter 3**.

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

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

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

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

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

4.8 Press articles

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

4.9 GAD’s 1998 survey on reserving for annuity guarantees

4.9.1 Following the publication of the report of the Working Party of the Life Board of the Faculty and Institute and, we were told in interview, because GAD was unable to access the confidential working papers, GAD initiated its own survey of life companies’ approach to reserving for annuity guarantees. The survey was initiated in June 1998. We have been told that the reason why the survey was initiated more than six months after publication of the Working Party’s report was that GAD wished to obtain full details of GAO policies and the valuation basis for those policies as included in the 31 December 1997 regulatory returns. Most insurance companies have a year end of 31 December. The regulatory returns are presented to the regulator and published on or around 30 June of the following year. Accordingly, by sending out the survey in June 1998, GAD sought to ensure that the information in the responses to the survey would be as up to date as possible and would also reflect how actuaries had reacted to the profession’s survey and subsequent discussions. The survey responses would also be able to be reconciled, by GAD, with the information contained in the latest regulatory returns.

⁷ This figure varied from year to year.

⁸ “Zillmer” adjustments are described in **Chapter 3**.

- 4.9.2 On 29 July 1998 the Appointed Actuary, on behalf of Equitable Life, submitted a response to the GAD survey. A copy of that response appears on HMT-ID's files and we were told at interview that HMT-ID first saw this in September 1998. The response showed that Equitable Life had made no explicit provision for annuity guarantees in setting its resilience or mathematical reserves⁹ and that Equitable Life's investment policy did not take account of the guarantees. The response also showed that the Appointed Actuary had seen the Working Party's report on reserving for annuity guarantees and that Equitable Life's approach had not been modified by the "recent debate" on annuity guarantees in the actuarial profession.
- 4.9.3 In the response to the survey the Appointed Actuary stated that Equitable Life's approach to setting terminal bonus rates for a cohort of policies was influenced by whether or not an annuity guarantee was biting. The Appointed Actuary described how the terminal bonus was adjusted as follows:
- "For any policy for which the annuity guarantee is biting, the amount of terminal bonus is reduced to pay for the cost of the guarantee. For all but a few small policies the "cost" of the annuity guarantee is covered by this adjustment."
- 4.9.4 Under "any other comments", the Appointed Actuary wrote:
- "The cost of annuity guarantees has more than adequately been covered by the terminal bonus cushion to date for all but a few small policies... As the business to which annuity guarantees apply ages, the increasing terminal bonus cushion will make it increasingly unlikely that guarantees will actually bite."
- 4.9.5 In response to the question "Are policyholders advised when they reach retirement of the existence of any available options to receive a guaranteed annuity?", the Appointed Actuary answered "no."¹⁰
- 4.9.6 In relation to all but one type of contract disclosed by Equitable Life as including a guarantee, in response to the question "Is the guarantee given to: (a) regular premiums paid at initial level (b) increments (c) single premiums (d) new members?" Equitable Life answered "yes" to each question (save for (d)). This was a matter which became very significant following the House of Lords' judgment when the difficulties of quantifying and predicting the level of increments which might be paid by GAR policyholders was raised as an issue by bidders for Equitable Life.
- 4.9.7 None of the information in response to the survey was passed on by HMT-ID to IB-PIA, the conduct of business regulator. At that time these were separate regulatory bodies with no formal mechanism for the co-ordination of their respective duties. IBD was subsequently told, in a memorandum of 3 September 1998, which referred to the GAD survey, that PIA would no doubt have an interest in the issue such as the extent to which companies are informing policyholders about the existence of a GAO at vesting.

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

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

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

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

with their GAO liabilities. That advice included a section on PRE. The advice noted:

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

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

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

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

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

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

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

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

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

- circulate all insurance companies referring to the issue of annuity options and guarantees and identifying the avoiding of these obligations as unacceptable behaviour;

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

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

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

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

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

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

4.13 Scrutiny Report

4.13.1 For a company such as Equitable Life which had been given a priority rating of 3 in relation to its 1996 regulatory returns, in the normal course of prudential regulation GAD would produce a detailed scrutiny of its 1997 regulatory returns within 6 months of receipt by the regulator. However, no detailed scrutiny was produced by GAD in 1998 in respect of its 1997 regulatory returns. GAD’s scrutiny of those

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

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

regulatory returns was combined with its scrutiny of Equitable Life's 1998 regulatory returns, which were submitted to the FSA in May 1999. We were told in interview that this was because Equitable Life was given a priority rating of 4 in 1997, and its regulatory returns would have been scrutinised in March 1998, although because of the ongoing dialogue with the regulator, GAD knew "where all the issues" were and scrutinised the 1997 returns, with the 1998 returns, in 1999. It is clear from the documents that the 1997 regulatory returns were considered, at least in part, prior to May 1999, because it is referred to in a briefing note given by HMT-ID to the FSA in December 1998, which is referred to in more detail below.

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

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

- (h) That for “several years now” the presentation of results for all pension contracts had focused on the open market option cash fund because that is what the vast majority of its clients had been interested in.
- 4.14.3 Equitable Life also explained that it had disclosed its terminal bonus practice in its regulatory returns since 1993.
- 4.14.4 With the letter, Equitable Life enclosed various items of literature about bonuses and policies.
- 4.14.5 On 1 October 1998 Equitable Life sent HMT-ID a facsimile enclosing a copy of the retirement annuity policy document which was used in the 1980s prior to withdrawal of the sale of contracts containing GAOs and a copy of Article 65 of the Society’s Articles of Association. As set out in **Chapter 3**, Article 65 gives the directors of Equitable Life discretion to make decisions in relation to the declaration and payment of bonuses.
- 4.14.6 On 2 October 1998 a meeting took place between Equitable Life, HMT-ID and GAD to discuss Equitable Life’s approach to terminal bonus and its reserving practice.
- 4.14.7 As to the terminal bonus practice, GAD expressed some doubts as to the clarity of the literature provided by Equitable Life and commented that a GAR policyholder could interpret it as indicative of entitlement to whichever of the current and guaranteed rates produced the higher figure. Equitable Life stated that it had been advised by Counsel that the Society was acting fully within its rights and that other offices were raising expectations by paying GARs on the full fund value.
- 4.14.8 As to the reserving practice, Equitable Life confirmed that no provision had been made for GAOs as at 31 December 1997 as it had only recently been the case that guarantees were biting on the guaranteed fund. Equitable Life argued that two-thirds of policyholders chose to take a cash benefit and so it would not be appropriate to reserve fully for all the guarantees. HMT-ID argued that Equitable Life needed to look at all guarantees and options throughout its policy base and make appropriate reserves. Equitable Life stated that the need to reserve for GAOs at the level required by the regulator could have severe consequences for the Society and that it might have to switch to investing in gilts to maintain solvency, but agreed to assess the need to provide reserves for GAOs along the basis outlined by HMT-ID and to make a reassessment of solvency.
- 4.14.9 There was also a discussion of reserving for increments. Equitable Life had disclosed in its response to the GAD survey in July 1998 that GARs did apply in most contracts to increments to existing policies. At the meeting Equitable Life agreed:
- “that many of their policies allowed the payment of additional premiums, but this was not seen as a risk because of the treatment taken with respect to asset shares. However, switches of policies into the Equitable were currently a risk but the company was looking to impose endorsements on any switches in to stop these policyholders gaining disproportionate benefits.”
- 4.14.10 The difficulties associated with quantifying the liability for and therefore reserving for increments was a matter the implications and significance of which were to emerge after the House of Lords’ judgment.
- 4.14.11 Thereafter, and until the end of the Inheritance Period, HMT-ID and GAD, in the course of correspondence and meetings, sought to ensure both that Equitable Life applied an appropriate level of reserves in respect of the GAOs and began to consider

whether the terminal bonus practice was in accordance with PRE. The next sections dealing with the Inheritance Period set out each of these strands separately. The reader should be careful not to form an impression as a result that these two issues were being dealt with separately. Correspondence and meetings often covered both topics.

4.15 Reserving for GAOs

- 4.15.1 During the autumn of 1998, following receipt of the response to the GAD survey, HMT-ID initiated a debate with Equitable Life and gradually imposed its view in relation to Equitable Life's reserving practice. HMT-ID conferred closely with GAD in the process and followed GAD's advice and lead on the interpretation of the relevant regulations. HMT-ID also sought advice from TAD, particularly in relation to its consideration of the options for intervention.
- 4.15.2 On 19 October 1998 HMT-ID sent a memorandum to the EST about the position of Equitable Life. Among other matters, the memorandum stated:
- “Meeting the cost of the guarantees is putting a significant strain on the company's resources and, as a mutual, it does not have the option of obtaining a capital injection from shareholders to relieve this strain. We have discussed the situation with the company and it has been agreed that it will submit to HMT updated information regarding its liabilities for GAOs and its resulting financial position in order that we can monitor this and take any action that becomes necessary to protect policyholders' interest. It is feasible that the company could have to consider some form of demutualisation, for instance through merger with another company, depending on how serious the financial situation proves to be.”
- 4.15.3 On 30 October 1998 Equitable Life wrote to GAD setting out the costs of various approaches to reserving. Equitable Life argued that the “commercial” cost of its guarantees was highly unlikely to exceed £50million. As to reserving, Equitable Life estimated that a reserve of £170million would cover all benefits taken in annuity form, assuming that policyholders would only choose the guaranteed annuity when it would produce a higher income than the cash fund at the current annuity rate.
- 4.15.4 GAD forwarded Equitable Life's letter to HMT-ID on 3 November 1998 noting that “it is not acceptable in this context to regard these guarantees as covered by a ‘First charge’ against a final bonus for which no provision is made. This has clearly not yet been recognised by Equitable Life (and they have not even attempted as we requested at the meeting [on 2 October 1998] to quantify the reserves on this basis).”
- 4.15.5 On 6 November 1998, HMT-ID wrote to Equitable Life setting out GAD's arguments and requesting further information and a meeting.
- 4.15.6 Equitable Life replied on 11 November 1998 stating that the basic additional reserve at 31 December 1997, on the basis requested by GAD, would have been around £675million, and gave estimates of the reserves based on various different valuation interest rates. The range given was estimated for the year ending 31 December 1998 and was £955million and £1375million. Equitable Life said that these figures should be increased by 10% and 20% in respect of the resilience reserves.
- 4.15.7 On 13 November 1998, GAD and HMT-ID met Equitable Life. Despite arguments from Equitable Life that policyholders taking the GAO were very much in the minority (because in many cases the margin of any GAO benefit was small), GAD and HMT-ID “argued that it was a statutory requirement to reserve on [the 100%

take-up] basis and unless the Equitable could put up a compelling argument to the contrary we would expect the company to reserve on this basis.”

- 4.15.8 Equitable Life was concerned about the timing of the potential need to reserve on the basis of 100% take-up rate and the potential commercial implications. Equitable Life agreed that thought would have to be given to reducing bonus declarations and agreed to provide an update on its latest free asset position.
- 4.15.9 Equitable Life wrote to GAD on 24 November 1998 setting out an explanation of how the GAO worked and arguing at length against GAD’s position. Equitable Life estimated surplus assets as at 30 October 1998, as £1164million and quantified the cost of GAO reserves on the basis which GAD was requiring as £1794million. Equitable Life pointed out that it had obtained a Section 68 Order allowing implicit items of up to £850million to be brought into account and that it would “not necessarily consider [a resilience reserve in accordance with the normal GAD guidelines to be] appropriate, if very substantial additional reserves were also required for guaranteed annuity rates.”
- 4.15.10 The letter identified choices available if reserving were required at the onerous end of the spectrum, including passing the bonus declaration, and indicated that the Appointed Actuary would “need to consider what steps to take in terms of consulting with the profession”.
- 4.15.11 There was a meeting on 3 December 1998 to discuss reserving matters, as well as PRE issues (the latter are referred to in more detail below). The Appointed Actuary reiterated Equitable Life’s arguments and noted that the Society’s reserving policy was not new, that GAD should have been aware from the regulatory returns that it was writing GAO business and that GAD had tacitly accepted its reserving basis. GAD rejected this argument. HMT-ID argued that there was at least a possibility that dissident policyholders might win a case in Court that they should be paid a guaranteed annuity on unadjusted terminal bonus. Equitable Life admitted that there was at least a potential contingent liability here. Equitable Life asked if there was any scope for HMT-ID to give any concession on this issue and what would be the consequences of not following this requirement. HMT-ID indicated that it could not see any scope for a concession in the circumstances. HMT-ID said that it would take appropriate measures to ensure compliance and when Equitable Life asked if there would be any way to appeal the matter, HMT-ID said that this would be limited to judicial review. Equitable Life said that it might have to take up that option. GAD expressed the opinion that “if the company had not been mistaken in its interpretation of the regulations it would not have been in the past so generous in its bonus declarations. Questions were also raised regarding the prudence of trying to operate a company without an estate.” Equitable Life said that they had not taken any legal advice on the issue of reserving. There was discussion about the bonus declaration and the possibility of using reinsurance as an option for “protecting the balance sheet”. The meeting note records that the Appointed Actuary “was concerned from a professional point of view that he was being forced to adopt a reserving approach that was ‘wildly prudent’ and he thought he would need to consult professionally regarding this.”
- 4.15.12 Following this meeting, intervention action was actively considered by HMT-ID.
- 4.15.13 On 7 December 1998, HMT-ID wrote to Equitable Life setting out its views in full and rebutting the arguments which had been raised by Equitable Life. In particular, HMT-ID did not accept that assuming a GAO take-up rate of 35% (as had been proposed by Equitable Life) was prudent, nor that a reserve based on the cash option should exclude terminal bonus. HMT-ID indicated that it would be willing to consider the possibility of treating a reinsurance arrangement as effective from the

year end provided that at least the broad terms of the agreement were in place by that date and that a firm intention to enter into the agreement could be shown.

- 4.15.14 In view of Equitable Life's continued resistance to HMT-ID's reserving arguments, GAD suggested, by way of internal memorandum to HMT-ID dated 8 December 1998 that it may be appropriate for the Government Actuary to discuss Equitable Life's approach to reserving with the Appointed Actuary if HMT-ID was proposing to take issue with Equitable Life's stance. Equitable Life told HMT-ID on 10 December 1998 that it had obtained "favourable" legal advice on the reserving question and that it was willing to take the matter to judicial review.
- 4.15.15 On 18 December 1998, Equitable Life sent HMT-ID a copy of a Joint Opinion of Leading Counsel. The Joint Opinion set out Counsel's view that Equitable Life's terminal bonus practice was wholly within the directors' discretion, that policyholders had no contractual right to have terminal bonus allocated to them, that the literature made it "abundantly clear" that terminal bonus was not guaranteed prior to actual allocation to the policy, that HMT-ID had been aware of the existence of the GAO policies from 1993 onwards and had not previously taken the point now being taken against the Society. HMT-ID's current requirement for reserving was manifestly unfair and would be open to judicial review on the basis that HMT-ID's current attitude was a breach of Equitable Life's legitimate expectations.
- 4.15.16 HMT-ID maintained its stance that Equitable Life was required to reserve fully for the GAOs. Internal legal advice was obtained by HMT-ID in relation to possible intervention action.
- 4.15.17 At a meeting on 22 December 1998 the debate on reserving continued. HMT-ID said that it would respond formally to the Joint Opinion on reserving when it had had an opportunity to consider it in detail. HMT-ID said that it was for Equitable Life to reserve as it saw fit, but it would take regulatory action if the reserves were inappropriate or Equitable Life's actions imperilled solvency margin cover. Among other matters, HMT-ID rejected the arguments raised in the Joint Opinion that HMT-ID had tacitly accepted Equitable Life's reserving practice. HMT-ID said that the information disclosed in the regulatory returns was limited and gave them no reason to question the validity of the reserving basis. GAD added that the report of the Working Party of the Faculty and Institute had concluded that holding no reserve for GAOs and assuming that the cost could be met from terminal bonus was "imprudent"¹³. Equitable Life argued that the requirement to reserve at 100% would disadvantage policyholders because it would constrain investment strategy. Equitable Life said that the consequent low solvency margin would threaten the Society's future and could put immense pressure on the Society to look for a buyer. HMT-ID agreed to consider any proposals which were transitional measures to soften the blow in relation to reserving. Equitable Life indicated that it was considering obtaining reinsurance for the reserves for guaranteed annuities.
- 4.15.18 On the same day, Equitable Life applied for a Section 68 Order for a future profits implicit item of £1900million. This was granted and a copy of the Order was sent to Equitable Life at the end of the year. On 31 December 1998 Equitable Life confirmed to HMT-ID that it had received an offer from an offshore reinsurer to enter into a reinsurance agreement.

4.16 Equitable Life's terminal bonus practice and PRE

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

- 4.16.1 During the Inheritance Period the activity and correspondence relating to Equitable Life's terminal bonus practice and PRE was principally directed at HMT-ID informing itself in order to be able to form a view on whether this practice was consistent with PRE.
- 4.16.2 Following the meeting on 2 October 1998 it was agreed at an internal meeting in early November 1998 that a meeting with Equitable Life should be arranged urgently in order to make it clear to Equitable Life that HMT-ID wished to satisfy itself that, *inter alia*, Equitable Life was conducting its business with due regard to the interests of policyholders¹⁴ and, more generally, whether Equitable Life's terminal bonus practice "accords with PRE".
- 4.16.3 On 12 November 1998 GAD provided HMT-ID with a background note for a meeting with Equitable Life which was due to take place on the following day. GAD suggested various questions should be raised relating to PRE and the terms of Equitable Life's contracts. The memorandum from GAD also listed certain documents which Equitable Life should be asked to provide, including copies of Board papers relating to the decision to grant lower bonuses to policyholders electing to take the GARs, copies of any communications prior to the 1995 bonus notice which might have indicated that a two-tier bonus system could apply and copies of any documents which supported the adoption of a two-tier terminal bonus system as a modification of policyholders' previous expectations.
- 4.16.4 At the meeting on 13 November, HMT-ID told Equitable Life that to understand the PRE implications it would want to see a selection of documents sent to policyholders and prospective policyholders. Equitable Life explained to HMT-ID that the Society had obtained a legal opinion from Leading Counsel which endorsed its position and Equitable Life agreed to provide copies of the Opinion and the instructions sent to Counsel as well as any Board papers required concerning Board discussions of the issue. HMT-ID asked Equitable Life about press reports which alleged that projections had been given to policyholders showing that the guaranteed rate was applied to unadjusted terminal bonus. Equitable Life said that, even if that had been the case, the level of terminal bonus had not been guaranteed, that the Society's principle was to pay out on the basis of asset share and that some policyholders had written in supporting its stance. HMT-ID explained to Equitable Life that in order to understand the PRE implications it would want to "get a feel for what impression had been given to policyholders over the years" and said that it would be writing to ask for a selection of documents. Equitable Life was asked about information given to policyholders on vesting:
- "[HMT-ID] felt that it was necessary to understand what information was given to clients on the GAO option for policies which were close to maturity. [Equitable Life] said that policyholders had a dialogue with the sales force and an illustration was given. It was added that the sales force tended to be in favour of the client rather than the company. The GAO option was covered in the illustrations only if it was more attractive to the policyholder."
- 4.16.5 On 16 November 1998 HMT-ID wrote to Equitable Life what action was required following the meeting on 13 November 1998. HMT-ID requested copies of literature provided to policyholders, Leading Counsel's Opinion and copies of the instructions which had been sent to Leading Counsel. The letter stated:
- "We are concerned that a policyholder with a policy where the GAO is biting to the extent that there would be no terminal bonus if the option is exercised will

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

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

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

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

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

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

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

4.16.8 In his Opinion, Counsel advised that:

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

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

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

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

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

4.16.12 Counsel advised that Equitable Life’s Board had discretion to award an extra allocation of terminal bonus to those policyholders who chose not to exercise their GAO although he also advised that the literature should reflect this practice, which should be adopted in future (in substitution for the current practice of reducing terminal bonus to policyholders who chose the GAR).

4.16.13 Leading Counsel made further detailed comments on the presentation and explanation in the bonus notices which he considered would “best serve the Society’s interests in the present circumstances.”

4.16.14 Equitable Life had also asked Counsel’s advice in relation to (a) increments paid by GAO policyholders and (b) transfers into the with-profits fund by GAO policyholders of the proceeds of a pension from another pension provider. In relation to increments, Counsel advised that if Equitable Life wanted to impose amended terms on such premiums it would have to do so:

“at or prior to the time of accepting any further premiums ... and would clearly have to consider the commercial implications of doing so before acting. What was clear, however, was that the possibility of imposing new terms prospectively prior to acceptance of an overdue premium could not now be relied upon in order to validate otherwise indefensible conduct in those cases where overdue premiums had been accepted in the past without the Society applying different terms at that time.”

4.16.15 As far as transferring funds into the with-profits fund was concerned, Counsel agreed that the current document used by Equitable Life to effect the transfer:

“did permit the Society to apply whatever terms it thought fit on transfers into the Society’s retirement policies, assuming the Society was otherwise permitted to refuse to accept such transfers. It was noted, however, that the Society would have to specifically impose the particular terms and that the current form of endorsement did not do that. The endorsement was being revised accordingly.”

4.16.16 The Settled Note of Consultation recorded that Counsel had advised that it:

“would be feasible but not tactically desirable (at this stage at least), to obtain a test case ruling on the matter. Better to sort matters out quietly, and to attempt to undo any damage done to date by getting a clear message across by correspondence, than to risk the publicity, cost and serious potentially adverse result of a court hearing.”

4.16.17 The advice disclosed that Counsel had prepared wording for a new form of bonus notice.

4.16.18 GAD's reaction to the advice in a memorandum dated 1 December 1998 was that it did "not wholeheartedly support the actions taken thus far by the Society". GAD stated:

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

4.16.19 GAD also noted that:

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

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

"Need to be clear how new documentation will be drafted

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

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

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

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

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

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

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

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

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

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

4.17 Other matters during the Inheritance Period

4.17.1 Concurrently with HMT-ID's correspondence with Equitable Life concerning reserving and its terminal bonus practice, HMT-ID was also engaged in the related matter of preparing guidance to the industry on GAOs. As a consequence of the emergence of GAOs as an industry-wide issue, it had been decided by GAD and HMT-ID to issue guidance on the question of charging for GAOs and PRE. The EST had requested a "read out" on the position of Equitable Life and its exposure to GAOs. At the same time as responding to that request, HMT-ID sent the EST draft guidance on the handling of GAOs to be sent out by HMT-ID to long-term insurance companies. There was a series of exchanges, both internal, and with the EST, which

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

shed some light on the thinking at that time within HMT-ID and GAD on the PRE aspects of charging for the guarantees and, in that context, Equitable Life's terminal bonus practice.

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

4.17.3 Each of these two issues is dealt with below.

4.18 Communications with the EST and the 1998 Guidance

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

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

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

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

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

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

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

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

The appropriateness of any such adjustments to bonus allocations for participating policyholders would need to be assessed by each office in the

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

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

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

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

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

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

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

4.18.6 Draft guidance was prepared by HMT-ID between 9 and 26 October 1998. On 26 October 1998, following a short telephone consultation with TAD about matters of form only (TAD had no industry experience to comment on the substance of the guidance), HMT-ID sent EST a memorandum seeking approval of the issuance of guidance on meeting the costs of GAOs. The covering note to the draft guidance stated that:

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

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

- 4.18.7 On 19 November 1998 HMT-ID received a note from the Assistant Private Secretary to the EST in response to HMT-ID's request for ministerial approval of the draft guidance. The note records the following:
- “The Economic Secretary is not at all happy with the proposal. The Minister has commented that surely if people bought a contract, it is a guarantee and they should not now expect to pay for the guarantee themselves. The Minister is minded to think that the shareholder should bear some/all? of the costs themselves.
- The Minister has asked about Orphan Assets asking if some appropriate use could be made where they exist. The Minister would welcome a fuller justification and consideration of other issues before she is prepared to agree a way forward.”
- 4.18.8 HMT-ID did not amend the guidance in the light of the EST's reaction. It provided the EST, as requested, with a “fuller justification of the proposed line on how insurers may meet the costs arising from guaranteed annuity options.”
- 4.18.9 On 24 November 1998 GAD prepared a note intended to assist HMT-ID to explain the position more fully to the EST. The memorandum noted that preparing the explanation to the EST “may then help us to identify more clearly where the draft letter may need to be modified.”
- 4.18.10 The memorandum stated that policyholders could reasonably be expected to pay some “premium” in advance for the GAO. GAD noted that in view of present investment conditions (with low yields on fixed interest securities) there may be a residual cost to the insurer of providing the guarantee over and above the accumulated charges received over the duration of the contract. Accordingly the guidance was suggesting that those residual costs could be met from either orphan assets or by the shareholders and that this was a legitimate expense to be charged to the long-term fund. The memorandum noted the particular difficulty for insurers without orphan assets or shareholders, such as Equitable Life. GAD stated:
- “In this situation, the ultimate residual cost of annuity guarantees falls to be met by either the policyholders who benefit from this guarantee or the remaining with-profit policyholders who share in the overall profits or losses for this business.
- Unfortunately, Equitable Life has given these guarantees on a substantial portfolio of its policies (with an associated policy liability equal to around 40% of the value of all with-profit contracts). Consequently, the residual cost of the guarantee is relatively large and will necessarily impact the total amount of bonuses that can be paid to policyholders.
- Contractually it is arguable whether it is obliged to spread the cost more evenly across all their policyholders, and we are seeking more specific information from them in this context.
- Nevertheless, the policyholders with these guarantees will have to meet at least part of the residual cost of these guarantees, even if this cost is shared across all policyholders. Moreover the remaining policyholders will undoubtedly complain if their bonuses are now reduced on this account.”
- 4.18.11 On 9 December 1998, HMT-ID provided the EST with more detailed background to the proposed further draft of the guidance letter and requested ministerial approval. The note included the following comments:

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

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

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

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

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

- 4.18.12 On 15 December 1998 the Assistant Private Secretary to the EST confirmed the EST's agreement to the issue of the guidance letter which had first been proposed in early October 1998.
- 4.18.13 Following a briefing meeting on Equitable Life which had taken place on 15 December 1998 between HMT-ID and the FSA, a facsimile was sent to Michael Foot, Managing Director of the FSA, dated 17 December 1998 to brief the FSA in relation to the proposed guidance. In the facsimile, HMT-ID stated that:
- “While the letter deliberately sets out general principles, application of which will produce different results depending on the individual offices' circumstances, but should ensure a consistent and fair approach overall, commentators are likely to see it as relating primarily to the Equitable. Some will see it as support for the Equitable's position; some will see it as a shot across their bows.”
- 4.18.14 On 18 December 1998 the guidance was issued by HMT-ID and sent to managing directors of life insurance companies. A copy of the guidance appears in full at **Appendix 1**.
- 4.18.15 Among other matters the guidance stated as follows:
- “Generally we consider that it would be appropriate for the level of the charge deemed to be payable by participating policyholders for their guarantee (or annuity option) to reflect the perceived value of that guarantee (or option) over the duration of the contract. This could be achieved in some cases through some reduction in the terminal bonus that would be payable if there were no such guarantee (or option) attached to the policy. However the selected treatment by each office would need to depend on the wording of the contract involved and how it had been presented to policyholders.”
- 4.18.16 The guidance also contained two important caveats. The first was that the treatment of the cost of GAOs by each firm “would need to depend on the wording of the contract involved and how it had been presented to policyholders.” The second was that “The above is the Treasury's considered view and is without prejudice to any decision of the courts that may affect it.”

4.19 Briefings to the FSA and IBD

- 4.19.1 In anticipation of the transfer of responsibility for the prudential regulation of insurance companies from HMT-ID to the FSA, a memorandum was sent by HMT-ID to Michael Foot on 3 September 1998. HMT-ID referred to the recent press interest in the issue of GAOs and informed the FSA about the GAD survey, the analysis of the responses which GAD was then carrying out and that HMT-ID was considering the implications for PRE. The note was also copied to IBD on the basis that that division would no doubt have an interest in some aspects of the issue, such as “the extent to which companies are informing policyholders of the existence of a guarantee at the time when they come to make choices about annuities on retirement”. The memorandum noted that this was “an example of an issue on which we will need to work together to ensure a seamless regulatory approach.”
- 4.19.2 A further briefing memorandum was sent by HMT-ID to the FSA and IBD on 5 November 1998 attaching the draft guidance letter referred to above relating to HMT-ID's interpretation of PRE in relation to GAOs and how companies could charge for the costs of GAOs. In the covering memorandum, HMT-ID expressed its concern as to Equitable Life's ability to reserve adequately: “The information received to date is unconvincing, and raises serious questions about the company's

solvency.” HMT-ID stated: “our preliminary view is that the Equitable Life is entitled to [pay the GAR only on the guaranteed sum not on the discretionary terminal bonus] though we are seeking further information to test the position further.” Michael Foot responded by a note stating that he thought that it was critical that HMT-ID seek further information for such purpose.

- 4.19.3 As part of a series of briefing meetings in anticipation of the transfer of the prudential regulation of insurance companies from HMT-ID to the FSA, a meeting was arranged between representatives of HMT-ID and Howard Davies and Michael Foot to discuss the position regarding Equitable Life. This was the only pre-handover briefing given to Howard Davies and Michael Foot relating to the problems of a particular company. A briefing note was prepared by HMT-ID and sent to the FSA setting out the free asset position if Equitable Life reserved for 100% or 25% of GAOs. The note stated that Equitable Life was just solvent if it reserved fully for its GAOs and, for the FSA’s information, set out the arguments on reserving.
- 4.19.4 The briefing note also stated:
- “However, it should be noted that the free assets figure makes no allowance for the declaration of bonuses. The costs of annual bonuses, assuming they are maintained at their current level is £500m, so the company would appear to have insufficient assets to declare a bonus in 1999. Also it should be noted that £850m of the assets available to cover the RMM are implicit items (allowance for future profits). Only 5/6th of the RMM can be covered by implicit items. The company is therefore close to breaching this requirement when GAOs are fully reserved for. A relatively small fall in equities or gilt yields could wipe out the company’s explicit free assets.”
- 4.19.5 The note set out a strategy for regulatory action. At a meeting before Christmas, Equitable Life was to be told that:
- (a) HMT-ID was not minded to take action against Equitable Life for its failure to reserve fully for GAOs in its 1997 regulatory returns;
 - (b) Equitable Life’s proposed reserving approach was not acceptable to HMT-ID; and
 - (c) it was for Equitable Life to decide the reserving approach which it intended to adopt in its 1998 returns but if the FSA decided that the regulatory returns were not compliant with the Regulations, the FSA would take action.
- 4.19.6 In addition, it was intended to seek an undertaking from Equitable Life that it would not declare any further bonuses without prior discussion with HMT-ID.
- 4.19.7 The note contemplated closing Equitable Life to new business and the steps which would be taken if Equitable Life indicated it was going to declare a bonus which would have the effect of making the company breach its RMM if full reserves were made for the GAOs.
- 4.19.8 The section on “other regulatory action to be taken” stated that in December 1998/January 1999 HMT-ID would analyse the policyholder documentation issued by Equitable Life in order to reach a view on whether the reduction of terminal bonuses to meet the cost of GAOs was consistent with PRE for all policies maturing before the 1998 year end. It also stated that in January 1999 HMT-ID would seek to issue a “Dear Director” letter to all life insurance companies setting out its interpretation of the reserving requirements for GAOs (that full reserving was

required) and stipulating that adequate disclosure was required in the regulatory returns of the reserving basis used for GAOs.

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

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

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

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

4.20 The position on handover to the FSA

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

Part 2

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

4.21 Introduction

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

4.22 Regulation of statutory solvency and reserving

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

4.23 GAD advice on the Joint Opinion of Counsel

- 4.23.1 As far as the Joint Opinion was concerned, GAD noted that Counsel had overlooked the key point that the prudent assumption about the proportions of policyholders who may exercise each option ought to depend on the relative value of the benefits. GAD considered that recent experience of take-up rates was irrelevant because an additional (discretionary) cash sum was being paid to those who chose the cash benefit rather than the guaranteed annuity. Therefore, in GAD's view, Equitable Life could not sensibly take account of the increased proportion who were taking the cash benefit, since Equitable Life did not propose to maintain any provision on the balance sheet for that additional cash bonus.
- 4.23.2 The Joint Opinion asserted that an insurer may take account of the existence of options to reduce the level of mathematical reserves. GAD questioned this interpretation of Regulation 72 (1) of the 1994 Regulations¹⁶. GAD said that if this had been intended, then the wording in Regulation 72 would have been "variation in liabilities" not "increase in liabilities."
- 4.23.3 GAD accepted that Equitable Life could make an allowance for mortality prior to policyholders attaining 60. However, no allowance could be made for transfers to other pension arrangements, because Regulation 74 of the 1994 Regulations prohibits any reduction in liabilities in respect of possible future voluntary discontinuance.

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

- 4.23.4 GAD also stated:
- “On the subject of the earlier 1993 - 1996 returns, I accept with hindsight that we might have addressed the issue rather earlier by asking some pointed questions about their guaranteed annuities. However, the presentation of their valuation methodology in their returns was somewhat obscure, and required the reader to pick up comments in three quite separate parts of the return and draw certain inferences from them. There was nothing said to indicate that the level or extent of these guaranteed annuities were regarded as significant.”
- 4.23.5 Equitable Life’s presentation in the regulatory returns is set out in **Part 1 of Chapter 4**.
- 4.23.6 The Opinion alleged, as Equitable Life had done at the meeting on 3 December 1998, that the regulator had “tacitly” accepted the reserving basis in the 1997 returns. GAD denied this: it said that there had not been any direct communication between GAD and Equitable Life about those regulatory returns.
- 4.23.7 GAD questioned Counsel’s comments that if the additional reserve had been required for GAOs at the end of 1996 or earlier that would have prevented the declaration of bonuses. GAD also noted that Equitable Life did not at any time seek to discuss the reserving basis with GAD or HMT-ID even when this had become a material issue for the Society.
- 4.23.8 GAD had some sympathy with the points made by Counsel regarding the size of the one-off reserve (£1.5billion) and the fact that to make it would affect all policyholders in the form of reduced bonuses in future years. GAD said that it could consider some phasing-in of higher provisions when it had seen some of the information which it had asked IFSD to request from Equitable Life, which should help them consider the ramifications of the increased provision in the context of PRE.

4.24 FSA response to the Joint Opinion

- 4.24.1 On 11 January 1999 IFSD assisted by GCD and following the advice from GAD referred to above, replied to Equitable Life’s letters of 18 and 31 December 1998 and set out some matters relating to the discussions which had taken place on 22 December 1998 regarding the standard of reserving required for the contracts containing GAOs.
- 4.24.2 In its letter, IFSD stated that the Joint Opinion had not changed IFSD’s view on reserving as set out in HMT-ID’s letter to Equitable Life dated 7 December 1998, and, most importantly, did not appear even to address IFSD’s position. IFSD’s main points are set out below.
- (a) IFSD made clear that the issue was not the contractual right to bonus (or lack of it) or any representation about bonuses. The issue was the reality that bonuses had to be adjusted in order to ensure that the value of benefits, if taken in guaranteed annuity form, was no greater than the cash fund available to provide for an annuity on current rates and that that practice would need to continue if policyholders were to be expected to opt for the cash fund; so the company’s discretion not to pay additional bonuses was substantially fettered.
 - (b) As far as cash commutation was concerned, evidence that most policyholders currently took this did not address the real issue.

- (c) The letter repeated the points in GAD’s advice relating to allowances for mortality and the prohibition on reducing liabilities in respect of voluntary discontinuance. IFSD also noted that “it would not in any event appear prudent to assume that policyholders would easily be persuaded to surrender their rights to a valuable annuity guarantee.”
- (d) IFSD responded to Equitable Life’s allegations that DTI and/or HMT-ID had been on notice of Equitable Life’s reserving practice since submission of its 1993 regulatory returns. This was denied, on the basis that the statements in the regulatory returns were “brief in the extreme and do not disclose the reserving method, the rate of guarantee or the volume of business affected.” IFSD noted that it would be raising the issue of reserving for GAOs with the industry shortly. IFSD did not consider that “the text of resolutions of the Society’s Board reveals that GARs actually exceeded CARs ... [and] DTI/HMT was not aware from 1994 that the GARs referred to were higher than CARs”, as asserted in the Joint Opinion.

4.24.3 IFSD said that its view:

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

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

4.25 Early submission of 1998 regulatory returns

4.25.1 On 7 January 1999 IFSD sent a briefing note to Howard Davies relating to the proposal to issue guidance to the insurance industry on reserving requirements for GAOs. The memorandum recommended that Howard Davies should consider, amongst other matters, the general industry draft guidance and that IFSD proposed to ask companies to submit their 1998 regulatory returns early where their 1997 regulatory returns were not prepared in compliance with the line set out in the guidance and where they presented a materially misleading impression as a result. The note stated:

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

- 4.25.2 The note set out the advantages and disadvantages of the following three options available to the FSA:
- (a) take no action in relation to the past regulatory returns;
 - (b) require correction of misleading 1997 regulatory returns; or
 - (c) require accelerated 1998 regulatory returns from companies who submitted “misleading” 1997 regulatory returns.
- 4.25.3 The decision was subsequently taken to proceed with the last of the three options, as recommended in the briefing note.

4.26 January 1999 guidance on reserving for GAOs

- 4.26.1 By a letter dated 13 January 1999 the Government Actuary issued guidance to all Appointed Actuaries of companies authorised to carry on long-term insurance business relating to reserving for GAOs. A copy of the guidance appears at **Appendix 2** to this Report. It is also explained in **Chapter 3**.
- 4.26.2 On 29 January 1999 GAD telephoned the Appointed Actuary to discuss matters arising out of a paper dated 22 January 1999 which the Appointed Actuary had produced for Equitable Life’s January Board meeting headed “Valuation and bonus declaration as at 31 December 1998”. The paper showed that the Appointed Actuary considered that the lowest proportions of benefits which he could assume would be taken in GAR form without, in his opinion, being found to be in contravention of the Government Actuary’s guidance, were between 65% and 80%.
- 4.26.3 In a file note of the telephone conversation, GAD recorded that “[the Appointed Actuary] was, in truth, rather vague as to how he justified the percentages of the total liabilities for which he assumed retirement benefits were taken in GAR form.”
- 4.26.4 GAD indicated that there would need to be further discussion of the adjustments which the Appointed Actuary was seeking to make in calculating the GAR liability before he could expect IFSD to accept those adjustments as producing acceptably prudent reserves.
- 4.26.5 In response to GAD’s questions, the Appointed Actuary advised that the GAR reserve included an allowance of £450million in respect of future premiums. Therefore the additional reserve held for existing GAR liabilities was actually in the region of £1billion:
- “Under questioning about the effect of moving to 90% of full GAR reserves, he suggested that perhaps another £150m might be needed - but, perhaps, he would then lower the allowance for future premiums to £300m at this time.”
- 4.26.6 GAD noted:
- “He seemed to be gradually accepting the ultimate need for establishing full provisions but appeared to be hoping that HMT would look kindly on the idea of phasing-in, which he suggested had received a favourable mention at an earlier meeting.”
- 4.26.7 In response to the guidance and IFSD’s covering letter regarding early submission of the 1998 regulatory returns, Equitable Life conceded that the reserving included in its 1997 regulatory returns had not been consistent with the guidance, but argued that early submission of the 1998 regulatory returns was unnecessary. IFSD did not

agree and threatened that regulatory action would be taken to require Equitable Life to make such early submissions if it did not do so voluntarily. On 26 February 1999 Equitable Life agreed to submit its returns early.

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

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

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

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

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

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

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

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

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

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

4.27.4 The advice further stated:

"The cost of the declared bonus for 1998 would be some £365 Million (compared with £508M in 1997). This would leave the overall financial position of the company as shown in their draft 1998 returns as showing cover of 250% for the solvency margin (ie similar to 31/12/97) assuming that the reinsurance with ERC is completed (and accepted by FSA as allowing a significant reduction

in the reserves for GARs), or 110% if the ERC reinsurance is not taken into account. In the latter situation, they would though be able to take credit for a larger future profits implicit item which could boost the apparent solvency margin cover to around 200%, though the explicit cover for the guarantee fund would be very thin.

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

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

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

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

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

4.28 The reinsurance agreement

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

- (a) The reinsurer was a Dublin-based subsidiary of ERC Frankona. GAD noted that it had no details of the financial strength of that subsidiary, IERC, or of the extent, if any, of any support which ERC Frankona might be prepared to guarantee IERC in respect of its potential liability.

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

- (b) The reinsurance was a financing arrangement which provided support to Equitable Life in any year when more than 25% by value of the guaranteed business vesting in that year select the GAO.
- (c) The cost of the reinsurance was £150,000 (increasing by RPI) for each year that the agreement remained in force.¹⁸
- (d) The reinsurance could be cancelled if Equitable Life changed its practice on GAOs “presumably including if it lost its Court case.” The terms of the cancellation clause in the final form of agreement were as follows:

“The reinsurance will apply so long as the Reinsured makes no change to its current practice regarding the exercising of guaranteed annuity options as represented to the reinsurer in the attached schedule (Appendix III). Should any change occur, either at the choice of the Reinsured or as a result of any legal action brought against the Reinsured, then no further Reinsurance Claims Events will be admissible. In that event, the reinsurance will be terminated at the earliest date at which no Recovery Amount is due.”
- (e) The intention of the reinsurance was to enable Equitable Life to maintain a reserve, in respect of policies with GARs, equivalent to providing for the additional cost of the guarantees on only 25% of the business rather than the near 100% which the regulator was requiring. GAD advised that it believed the reinsurance would not achieve the intended reserving effect. GAD set out its reasons, in particular that on cancellation: “the Equitable would be required to immediately repay any outstanding finance and increase its mathematical reserves.” GAD pointed out that this seemed to negate the benefit of the arrangement to Equitable Life, particularly where the reinsurer had an option to cancel the reinsurance, although GAD noted that there were various ways in which this might be resolved.

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

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

“The reinsurer provides surplus cover for the costs arising from the exercise of guaranteed annuity rates in respect of Retirement Annuity policies, Individual Pension Plans and Transfer Plans issued before 1 July 1988. If, in any calendar

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

¹⁹ Regulation 12(2).

year, the proportion of terminations due to retirements exercising the guaranteed annuity option exceeds 25% of the total retirements in that calendar year, as measured by the guaranteed funds for those policies, the reinsurer's gross liability is the value of the guaranteed annuity in excess of the guaranteed policy funds for that proportion of retirements effecting the guaranteed annuity option which is in excess of 25%."

4.28.4 The fact that the reinsurance agreement would apply as long as Equitable Life made no change to its terminal bonus practice was not disclosed in the regulatory returns.

4.28.5 GAD's advice dated 29 January 1999 on Equitable Life's proposed bonus declaration formed the basis of a telephone call in late January 1999 and a letter from IFSD to Equitable Life dated 1 February 1999. GAD's advice stated that Equitable Life's financial position shown in its 1998 regulatory returns:

"is likely to appear as reasonably satisfactory following their proposed declaration of bonus, though they would be potentially close to regulatory action under section 33 [of the ICA 1982²⁰] if their proposed reinsurance is not completed satisfactorily."

4.28.6 IFSD advised Equitable Life that, in the absence of a robust reinsurance agreement along the lines which had been discussed, IFSD would not consider it prudent for Equitable Life to declare any bonus for 1998. IFSD noted that in the absence of reinsurance, the cover for the solvency margin would appear so low that it could easily be eliminated by a small move in market conditions.

4.28.7 IFSD told Equitable Life that even with the reinsurance, the Society needed to consider carefully the scope for declaring a bonus because of the uncertainties surrounding the financial implications of the Court case:

"In particular it would appear necessary for Equitable Life to consider the prudence of declaring a bonus in the light of the risk of losing the Court case and the potential costs that might be incurred as a result. We also consider it necessary for the company to take account of the risk, even after the terms of the reinsurance treaty have been revised as discussed with GAD, of the treaty being cancelled by the reinsurer (whether as a result of Equitable losing the Court case and having to change its payment policy, or for some other reason) because of the heavy dependence of the company on the reinsurance treaty in order to be able to show more than marginal solvency coverage. We consider these points to be, in the first instance, a matter of judgement for Equitable Life, on which the company must satisfy itself appropriately."

4.28.8 IFSD confirmed that, on the basis of the information received and assuming the reinsurance agreement was revised to resolve GAD's concerns, it was not minded to object to the proposed bonus declaration. IFSD asked to be kept informed on progress relating to the revision of the terms of the reinsurance agreement in order to take this into account in reaching "a final view" on the bonus declaration. The letter stated that any decision by the FSA not to intervene over the bonus declaration was not the end of the matter, and that the regulator remained concerned about the ongoing financial health of Equitable Life because of the relatively low level of explicit free assets²¹ and the apparent sensitivity of free assets to future rates of investment return. In order better to understand the key factors influencing Equitable Life's longer term solvency position, IFSD requested various projections and

²⁰ See Chapter 3.

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

contingency plans as suggested by GAD in its advice on 29 January 1999, referred to above.

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

4.29 Equitable Life issues proceedings

- 4.29.1 In January 1999, while discussions between Equitable Life and IFSD in relation to reserving, reinsurance and the 1998 bonus declaration were taking place, Equitable Life prepared to issue Court proceedings in relation to its terminal bonus practice.
- 4.29.2 On 15 January 1999 Equitable Life issued an Originating Summons in the High Court seeking declarations from the Court affirming the validity of the decisions of the directors to apply differential terminal bonuses to GAR policyholders.
- 4.29.3 In its Originating Summons Equitable Life sought the following relief from the Court:
- “ (1) A declaration that [Equitable Life's] Board is entitled to exercise the discretion conferred by Article 65 so as to allot or otherwise make available different amounts of final bonus to Policyholders whose benefits become payable at a time when guaranteed annuity rates applicable to them under their Policies are higher than current annuity rates, so as (so far as is possible having regard to the amount of the surplus available for the provision of final bonuses in respect of such Policies and to [Equitable Life's] obligation to equalise the total value of the benefits taken by any given Policyholder interested under a Policy which contains provision for guaranteed annuity rates irrespective of whether such Policyholder elects to take an annuity to which such guaranteed annuity rates apply.”
- 4.29.4 A second declaration sought confirmation from the Court that, if the Board of Equitable Life was entitled to exercise its discretion in allotting differential terminal bonuses, it had done so validly.
- 4.29.5 The Summons also requested that, in the event that the Court found that the Board of Equitable Life was entitled to exercise, but had not (in the past) validly exercised, its discretion, the Court make an alternative declaration, that the Board may now exercise its discretion so as to equalise the total value of benefits taken by GAR policyholders.
- 4.29.6 On 23 February 1999 the Court had ordered that Mr Hyman was to represent the interests of all policyholders or former policyholders of Equitable Life who had an interest in a policy containing a provision for GARs. The Court also ordered that Equitable Life was to represent the interests of all other with-profits policyholders. The Court Order expressly stated that it did not preclude any policyholder from seeking relief based on allegations as to the way in which policies were sold to him individually if those allegations were based on facts which were not before the Court. The FSA saw this Court Order for the first time in mid-June 1999.
- 4.29.7 Equitable Life did not send IFSD a copy of the Originating Summons or evidence in support until mid-June 1999. The evidence in the case was finalised in March and May 1999. Copies were requested by IFSD in mid-June 1999, shortly before the First Instance hearing, although GCD had indicated internally in late January 1999 that it would be helpful to see the Court papers.

4.30 PRE

- 4.30.1 In late December 1998 and early January 1999 there had been some internal consideration of whether Equitable Life's terminal bonus practice was in accordance with PRE.
- 4.30.2 In an exchange of e-mails with GCD on 26 and 27 January 1999, whilst advising on whether it was appropriate to disclose the 1998 guidance letter to the public, GCD enquired whether IFSD would be continuing to consider "the PRE issue" while the matter was also before the Courts. GCD remarked that it was:
- "becoming increasingly clear that any decision by the FSA on the PRE issue (to intervene or not) is likely to be viewed by the Courts as unfair if policyholders are not first formally invited to make submissions on the matter to the FSA (although not necessarily on an individual basis). We are concerned with the PRE issue because complaints have been made. We have so far considered the views of and the material provided by, but only by, the Equitable. Although we have asked for extensive information from the Equitable, there is nevertheless a reasonable possibility that something will be missed or misconstrued by the FSA and which might be corrected, or at least challenged, by policyholders. Hence there is a real risk that any decision would be overturned by a Court on fairness grounds (or because a relevant consideration had not been taken into account)."
- 4.30.3 GCD considered that if IFSD continued to examine the documents and submissions from Equitable Life, but held back from any decision or tentative decision on PRE until judgment was handed down, considerations of the fairness issue could be postponed until then. This prompted IFSD to conclude, as recorded in an e-mail dated 26 January 1999, that:
- "As a matter of policy, [our] strong preference is not to reach a decision on PRE until after the Court case. ([We] understand that the Court decision will not in principle preclude FSA taking a view on whether to intervene on PRE grounds; but in practice, the judgement as to whether PRE has been met or not will depend crucially on the precise nature of the individual contracts, as well as what policyholders were told; so that it would be sensible to await the Court's decision on the legal position)."
- 4.30.4 IFSD agreed that while it would be best to wait for the result of the case before taking a view on the PRE issue, it considered that it "should do some of the ground work in the interim." In interview, Michael Foot told us that he was privy to this decision to defer consideration of PRE.
- 4.30.5 IB-PIA, who had been told by HMT-ID in late 1998 that it was considering the matter and who had asked to be kept informed about HMT-ID's work on this matter, was not party to the decision and was not informed about it by IFSD.

4.31 FSA perception of Court case

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

Equitable Life had been very positive about the Court outcome (which we believe to have been on 29 June 1999), GCD gave oral advice to IFSD and GAD along the following lines:

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

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

“it’s hard to imagine on what basis we would have become involved. Clearly we couldn’t become involved as Amicus²² because as a Regulator it would have been completely inappropriate. ... To have intervened on a public interest basis ... would also have been very difficult to justify and the courts actually do look very hard at whether there is a real reason for a public sector body to intervene on public interest grounds ... Here, the Court was simply looking at the contract and the exercise of discretion in terms of contract - private law terms - and although maybe there was a bit of debate around the margins about the extent to which PRE would be relevant to the issues, it is pretty hard to imagine how we would have had anything to offer on issues of contract and issues of exercise of directors’ discretion, when we have got no particular expertise.”

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

4.32 Report to FSA Board

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

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

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

4.33 IFSD Report on potential risk from GAO exposure

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

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

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

“We remain concerned about the financial viability of the company in the longer term. It has declared high levels of guaranteed bonuses in the past and its ability to honour these guaranteed bonuses appears heavily dependent on the company continuing to achieve high investment return. The company's liabilities for GAOs could also increase significantly if the yields on long gilts fall further.”

4.34 Submission by Equitable Life of its 1998 regulatory returns

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

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

4.35 Initial scrutiny of Equitable Life's 1998 regulatory returns

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

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

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

4.35.3 Accordingly, IFSD wrote to Equitable Life on 15 April 1999 requesting a copy of the finalised reinsurance agreement and also seeking a note of Equitable Life’s revenue and solvency projections and contingency plans which had previously been requested by the FSA in a letter dated 1 February 1999.

4.35.4 Equitable Life responded on 20 April 1999 confirming that the reinsurance agreement had not been finalised and enclosing a copy of the term sheet on which the agreement would be based. The letter stated that the solvency projections, which had been requested on 1 February 1999, were not yet available. Equitable Life did, however, enclose a copy of an Equitable Life Board paper dated 18 March 1999 setting out the measures open to Equitable Life to protect its statutory solvency position. In that paper, the Appointed Actuary identified a number of measures which he considered that “it would seem sensible for the Society to pursue”:

- “(i) Take on further subordinated debt.
- (ii) Use reinsurance to alleviate the capital strain caused by certain products, particularly the managed pension.
- (iii) Make some shift in the equity portfolio from lower-yielding to higher-yielding stocks.
- (iv) Limit the extent of exposure to development property situations.
- (v) Investigate the merits of introducing a new bonus class for business incorporating GARs and actively encouraging policyholders to give up their GARs.
- (vi) Gradually introduce new products with no entitlement to declared bonuses.”

4.35.5 On 21 April 1999 GAD advised IFSD, in response to their question on the point, that although the reinsurance agreement had not been signed, the intention to enter into it was sufficient for Equitable Life to rely upon it in its regulatory returns because GAD believed the ISC had agreed in principle that where there was a letter of intent in place then credit may be taken for a reinsurance agreement.

4.35.6 On 27 April 1999 GAD provided its comments to IFSD on the Equitable Life Board paper dated 18 March 1999, relating to measures available to Equitable Life to protect its statutory solvency position. GAD commented that the possibilities of increasing subordinated debt, sustaining a future profits implicit item at about 5/6ths of RMM and to seek to raise further financial reinsurance (on specific products with onerous capital requirements) looked fairly plausible, but “may only have marginal financial impact, bearing in mind the existence now of the overarching treaty with

ERC Francona.” GAD also commented that Equitable Life’s suggestion of strictly applying policy conditions to limit the impact of existing GAOs would have a strong adverse impact on the image of the Society, while the idea of “threatening” GAO policyholders with a 1% reduction in credited annual rate of return, with the option of giving up their GAO in exchange for receiving bonuses at a higher rate, might be in conflict with statements made in product and marketing literature. GAD commented that the idea of designing a new participating product with no entitlement to declared bonuses was imaginative.

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

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

4.37 Dialogue with Equitable Life on solvency issues - May 1999

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

- “17. ‘Central’ - a modest rise in gilt yields to 5% coupled with broadly unchanged equity values
- ‘High’ - a more significant rise in yields with gilt yields rising above 6% and equity prices falling around 5%
- ‘Low’ - further reductions in yields with gilts falling to around 3.5% and equity prices rising by around 8% ...
- 18. The 31.12.99 projected solvency position arising from these scenarios are as follows (figures related to non linked business only):

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

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

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

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

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

4.37.3 The Appointed Actuary thereafter noted:

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

	1999	2000	2001	2002	2003
Central conditions [a modest rise in gilt yields to 5% coupled with broadly unchanged equity values]	2.6	2.8	3.0	3.3	3.6
Alternative scenario (per paragraph 28)	2.1	2.2	2.5	2.9	3.3

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

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

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

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

4.38.2 The report noted that:

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

...

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

4.38.3 The report recorded the following "Action Points":

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

4.38.4 The report also referred to the Court case:

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

4.38.5 On 25 May 1999 there was an exchange of e-mails between IFSD and GAD which record that IFSD had agreed internally that a "low profile" approach to obtaining clarification of the basis for Equitable Life's level of reserving for GAOs was the best way forward and that GAD should write to Equitable Life accordingly. In interview it was explained to us that a "low profile" approach meant, in the first

instance, finding out why the reserve had been set at that level, which would be appropriate for GAD to do by raising it as a detailed point arising out of the scrutiny of the regulatory returns. An approach by GAD would be seen as a technical matter, whereas if the matter was raised by IFSD, Equitable Life would have thought that IFSD had already concluded that the level of reserving was inappropriate. In interview GCD told us that it would have been difficult to justify intervention if Equitable Life had reserved at 80% or higher, since Regulation 64 of the 1994 Regulations required valuation of liabilities on “prudent assumptions” and prudence was a matter of actuarial judgement in each case.

- 4.38.6 In order to clarify the position, GAD wrote to the Appointed Actuary on 27 May 1999 seeking an explanation of the assumptions used to arrive at the expected proportion of policyholders taking their benefits in guaranteed annuity form. The letter also sought clarification as to how the reinsurance offset had been calculated in the regulatory returns including an explanation of how allowance was made in the returns for the premiums payable to IERC if the reinsurance was called on. GAD also requested supplementary information in support of the projected solvency information provided on 4 May 1999.
- 4.38.7 The Appointed Actuary replied to GAD on 25 June 1999 explaining how the level of the reserve for guaranteed annuities had been calculated and specific reductions had been made for a range of factors considered likely to reduce the proportion of policyholders who would actually exercise their GAO:
- (a) for all types of contract - a 5% reduction in the proportion assumed to take the guaranteed option because of the bonus system operated by the Society;
 - (b) for perceived flexibility and other perceived advantages of alternative forms of benefit: for group pension business and for retirement annuities, a 10% reduction and for individual pensions and transfer plans, a reduction of 5%;
 - (c) for cash commutation options:²³ retirement annuity 15%; individual pension/transfer plan 7.5%; for group pensions 2.5%.
- 4.38.8 As regards the reinsurance offset, the Appointed Actuary stated:
- “The reinsurance offset has been calculated assuming that any guaranteed benefits taken in guaranteed annuity form above 25% are covered by the reinsurer to be paid back from future surpluses. The value of the deposit premium of £400,000 p.a. has been calculated assuming it increases in line with RPI and has been deducted from the reinsurance offset. The risk premium of 2% of any outstanding claim amount should the reinsurance be called on is payable out of future surpluses and therefore, as discussed on previous occasions, has not been included in the reserves for guarantees.”
- 4.38.9 The Appointed Actuary answered the other points in GAD’s letter including confirmation that the 1.4 times cover for the Society’s solvency margin was projected at the end of 1999 assuming gilt yields remained static, equities fell by 10% over the year and a bonus _% below that for 1998 was declared.
- 4.38.10 On 15 July 1999, when judgment in the Court case (which was in fact given in September 1999) was expected within a few days, GAD replied to the Appointed Actuary’s letter of 25 June 1999 and stated:

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

“As you might appreciate, we intend to defer formal consideration of your justifications of the proportions assumed to take the benefits in guaranteed annuity form until we see the outcome of the court case. However, I would say that we do still have some difficulty in accepting that reductions of between 17% and 30% are consistent with the “few percentage points” quoted by the Government Actuary in paragraph 6 of his letter dated 13th January 1999.”

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

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

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

4.38.13 There was no further correspondence on this issue between the regulator and Equitable Life, save for the publication by the Government Actuary of reserving guidance, which was sent to all life insurance companies in December 1999, until GAD raised the matter again during its scrutiny of the 1999 regulatory returns in late November 2000. The issue was raised with IFSD by GAD in September 1999, when GAD stated that it was not inclined to pursue the matter with Equitable Life at that time because, while the reinsurance agreement was effective, reserving at the higher level would not affect Equitable Life’s net liability.

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

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

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

1. Equitable Life win totally;
2. Equitable Life win in part, its past practice being found unacceptable, but current practice acceptable;
3. Equitable Life win (in total or in part) but the PRE perspective referred to the FSA; and

4. Equitable Life loses, it being found that to reduce terminal bonus where a GAO is exercised was unacceptable.
- 4.39.3 Under Scenario 3 one of the implications for the FSA was that the FSA would have to “reach a public view on PRE in the context of GAOs” and the FSA:
- “Expect to conclude Equitable current bonus practice is consistent with PRE but more doubtful about whether same could be said of past practice (because bonus notices of dubious clarity in the past).”
- 4.39.4 It was also noted that IFSD needed to try and define some more detailed criteria for determining when a reduction in terminal bonus was/was not consistent with PRE. In the final draft, Scenario 3 was removed because, we were told in interview, it was decided that the FSA would need to review the consistency of Equitable Life’s bonus practice with PRE irrespective of whether or not the Court specifically referred the matter to the FSA.
- 4.39.5 One of the implications of Scenario 3, of the draft scenarios circulated on 8 June 1999, was stated to be that:
- “Company would need to look at reducing substantially terminal bonus payable to all policyholders (*or those with a GAO irrespective of whether it was exercised?*)”
- 4.39.6 The draft scenarios were amended after a meeting with Equitable Life on 29 June 1999 and were sent to Michael Foot and IB-PIA on 5 July 1999. We have been told that at that meeting Equitable Life told IFSD that if the Society lost the Court case it would look at meeting the cost of GAOs from GAO policyholders as a class. This was reflected in the amended version of the scenarios:
- “Company would need to look at reducing substantially terminal bonus payable to policyholders with a GAO irrespective of whether it was exercised (or all WP pension policyholders if this was not accepted by the Court).”
- 4.39.7 The draft scenarios also set out various steps that would need to be taken in the event of a takeover bid, the likely effect of a fall in new business and the need to monitor Equitable Life’s surrender values to ensure that they were not so generous as to increase the lapse rate and thereby adversely affect Equitable Life’s solvency.
- 4.39.8 GAD’s view of the draft scenarios was that they should be considered alongside the projections which had been presented to the Equitable Life Board at the end of April 1999. GAD noted that the paper provided projections which included the possibility of losing the Court case together with various other assumptions. GAD advised that all the projections made by Equitable Life assumed that from the end 1999 position future annual investment returns were in the region of 6% to 7% and were adequate to generate fairly high levels of annually emerging surplus (probably in the region of £1billion).
- 4.39.9 GAD’s note continued:
- “By modifying future payout levels, and also by restraining levels of reversionary bonus declaration, the Society is then able to steadily recover a reasonably strong disclosed financial position - although [the Appointed Actuary] does admit that in the ‘low’ investment yield scenario ‘the position would become impossibly tight’.

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

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

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

4.39.11 On 16 June 1999, following a telephone call from IFSD to Equitable Life, the Society’s solicitors sent certain papers which had been submitted to Court to IFSD. These were reviewed separately by IFSD and GAD and “skimmed” by GCD. GAD prepared a note commenting on the papers on 22 June 1999.

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

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

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

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

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

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

4.40.4 One of the affidavits in the Court proceedings sworn on 3 March 1999 on behalf of Equitable Life (and received by IFSD on 16 June 1999) set out the consequences if the declarations which the Board of Equitable Life sought were not granted by the Court. One of the relevant variables affecting future bonuses was how the costs of providing “higher” benefits to the GAR policyholders would be spread among other with-profits policyholders. The affidavit stated as follows:

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

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

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

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

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

4.41.2 Following discussions with GCD about PRE, a memorandum dated 25 June 1999 was prepared by IFSD which dealt with the type of action which IFSD might need to take on PRE in the event that the Court decided that PRE was not relevant to the case. We have been told in interview that IFSD's doubts about the consistency of Equitable Life's terminal bonus practice with PRE remained "significant" at this time. The memorandum (which was not copied to IB-PIA or IBD) also reported that the format of Equitable Life's bonus notices had been raised with the PIA and that it was considered by IFSD that the bonus notices were the main factor in support of the argument that Equitable Life's approach was not consistent with PRE. The memorandum records that the format of the bonus notices had been raised with Equitable Life in the past, before the GAO issue arose, but that no progress had been made in persuading Equitable Life to change them. IB-PIA provided its views in September 1999, as set out below.

4.42 Meeting with Equitable Life on 29 June 1999

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

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

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

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

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

- (c) Equitable Life expected to appeal if the outcome was that its approach was ruled invalid and would ask the Court for approval not to change its bonus practice or pay compensation pending the outcome of the appeal.

- (d) It was confirmed that none of the measures described in the Board paper supplied on 20 April 1999 had been implemented but were being retained as contingency plans. Those measures included:
 - (i) subordinated debt;
 - (ii) future profits implicit items;
 - (iii) financial reassurance;
 - (iv) protecting the GAR exposure;
 - (v) making changes to the investment mix;
 - (vi) use policy conditions to restrict growth in guarantees;
 - (vii) product design; and
 - (viii) business mix.
- (e) IFSD made it clear that even if Equitable Life won the Court case it would still need to consider whether the bonus practice was consistent with PRE. Equitable Life was told that IFSD had some concerns about what policyholders had actually been told in bonus notices and that IFSD had not yet reached a view on this.
- (f) Equitable Life confirmed to IFSD that it had adopted the new approach to bonus payments which had been recommended by its legal advisers. This was to award an additional cash sum to policyholders who did not exercise a GAO. IFSD asked to be sent a copy of the current form of bonus notice and other literature sent to policyholders.
- (g) Equitable Life confirmed that new business levels were holding up well and turnover of sales staff remained low. The Society would continue to follow its philosophy of paying out as much as possible in bonuses and not building up an estate. The absence of an estate was seen by Equitable Life as a good deterrent to predators.
- (h) Arrangements were made to co-ordinate any press handling issues that might arise from the case.

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

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

4.42.5 On 30 June 1999 the Appointed Actuary wrote to IFSD enclosing a typical bonus notice for 1998 as requested at the previous day's meeting for the purpose of

assisting in the assessment of PRE. IFSD sent this to IB-PIA for its views as to whether or not it was misleading. IB-PIA's views on the bonus notices and communications between different teams within IBD are set out in **Chapter 5**.

4.43 Monitoring the High Court hearings

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

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

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

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

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

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

4.43.4 The memorandum noted that Equitable Life was co-operating “fully” over the issue and would be providing IFSD with transcripts of the hearing so that IFSD could monitor developments.

4.43.5 The memorandum also reported that PIA was considering the presentation of Equitable Life's bonus notices: “It appears to us that the notices may be misleading to policyholders because of the emphasis they place on the projected total fund value which includes terminal bonus although it is not guaranteed.”

4.43.6 The scenarios which were attached to the memorandum were as set out below.

- 4.43.7 Scenario 1 was described as follows: “Equitable win totally (past and current practice of reducing terminal bonus is acceptable within the terms of the contract).”
- 4.43.8 Scenario 2 was described as “Equitable win in part (current practice of reducing terminal bonus acceptable but past practice unacceptable).” The implications for Equitable Life were stated to be:
- (a) Equitable Life would continue its current terminal bonus practice;
 - (b) the reinsurance agreement would provide the anticipated GAO reserving cover;
 - (c) some compensation would have to be paid to some policyholders but the cost was unlikely to be substantial relative to Equitable Life’s reserves (possibly £400million);
 - (d) possible further downgraded credit rating which may cause significant reputational damage;
 - (e) Equitable Life would remain in a solvent but relatively weak financial position for a with-profits office;
 - (f) the judgment might be appealed by either side; and
 - (g) there may be a surge in surrenders and retirements.
- 4.43.9 The implications of Scenario 2 for the FSA were as follows:
- (a) FSA would need to continue to monitor solvency closely and the effect on surrender/retirement rates;
 - (b) the PIA Ombudsman would need to resolve complaints cases;
 - (c) IFSD would need to consider whether PRE warranted intervention or whether the court ruling should be considered definitive on policyholder interest; and
 - (d) IFSD would need to review the 1998 guidance and to discuss the implications of the judgment with other firms.
- 4.43.10 Scenario 3 was described as “Equitable lose (reducing terminal bonus where GAO exercised is unacceptable)” and the implications for Equitable Life were considered to be as follows:
- (a) GAO reinsurance invalidated if Equitable Life’s terminal bonus practice changes (although this may not be immediate if there is an appeal);
 - (b) without the reinsurance Equitable Life is likely to only just be able to cover its RMM after taking full account of future profits implicit items;
 - (c) Equitable Life would need to look at reducing substantially terminal bonus payable to policyholders with a GAO irrespective of whether it was exercised (or all with-profits pension policyholders if this was not accepted by the Court);
 - (d) Equitable Life would aim to cut bonuses gradually over 3 years in order to meet PRE - (this might precipitate a takeover bid, a significant reduction in

new business, an increase in lapse rates and policyholders retiring early to beat terminal bonus cuts);

- (e) Equitable Life would need to consider switching from equities to gilts to protect its solvency position;
- (f) Equitable Life would need to pay compensation to policyholders who had exercised GAOs and suffered reduced terminal bonus payouts as a result; and
- (g) Equitable Life's credit rating is likely to be reduced further which may cause significant reputational damage.

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

- (a) It was likely that IFSD would not need to form a judgement on whether intervention action was warranted on the grounds of PRE.
- (b) IFSD would need to determine the solvency of Equitable Life. If it was in breach of RMM then IFSD would need to issue a section 32²⁴ notice requesting a short term financial scheme for restoration of a sound financial position. If RMM was not breached, IFSD would still need to obtain financial projections to see how Equitable Life intended to increase its financial strength in the short to medium term.
- (c) If there was a significant risk that the company would be unable to meet its liabilities to policyholders or PRE then IFSD would need to consider closing the company to new business or suspending its authorisation.
- (d) Close monitoring of the company's business against the scheme/projections would be needed.
- (e) IFSD would need to assess the consistency of speed of bonus reductions with PRE and the practical effect on payouts.
- (f) Equitable Life might need to be encouraged by IFSD to reduce surrender values relative to maturity values.
- (g) IFSD would need to be alert to the potential wider loss of confidence in the industry.
- (h) If there was a takeover bid, the FSA would have no authority to protect Equitable Life from it. The FSA and Independent Actuary and the Court would scrutinise the terms of the transfer to check that they were fair to policyholders.
- (i) If there was a fall in new business then this would reduce new business strain and help bolster the financial position in the short to medium term.
- (j) IFSD would need to monitor the lapse rate to ensure that it is not so high as to affect the solvency position. IFSD would also need to address the concern that policyholders might be losing out through early surrenders. There would be a potential for an allegation that the FSA should have

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

prevented Equitable Life from writing new business earlier so that lapses could have been avoided.

- 4.43.12 On 15 July 1999 Michael Foot reported to the FSA Board that the case had begun and that IFSD was undertaking some “contingency planning”.
- 4.43.13 At this time the judgment was expected to be handed down in July before the Court vacation. However, in the event, judgment was given in September. Following receipt of copies of the transcripts of all three days of Court hearings, a summary was prepared and distributed internally on 12 August 1999. The overall conclusion set out in the summary was that the decision could go “either way” (GCD commented in manuscript that it agreed that it was “impossible to call”) but the note stated that the most likely outcome was that Equitable Life would win but would be criticised for not making its approach clearer. It was noted that both sides played down the PRE issue.
- 4.43.14 On 8 September 1999 at a meeting of ExCo, it was reported that judgment was due in the case of *Equitable Life v Hyman* on the following day. The minutes record that “It needed to be considered how the FSA would respond.”

4.44 Judgment of the High Court

- 4.44.1 On 9 September 1999 judgment was given in favour of Equitable Life by the (then) Vice-Chancellor, the Rt Hon Sir Richard Scott. The main finding of the judgment was that Equitable Life had not acted in breach of contract and its directors were entitled to exercise their discretion so as to declare differential terminal bonuses to GAR policyholders who exercised their GAO. The precise meaning of the Vice-Chancellor's comments about PRE were not clear to the FSA and were considered internally by some to be critical of Equitable Life. Mr Hyman, the representative policyholder, was granted permission to appeal to the Court of Appeal.
- 4.44.2 The headnote to the Vice-Chancellor's judgment appears at **Appendix 4**.

4.45 Reactions to the High Court judgment

- 4.45.1 On 9 September 1999 GAD sent an e-mail to IFSD, copying in GCD with comments on the judgment and GAD's understanding of the Vice-Chancellor's conclusions on PRE. GAD noted that it had not seen anything in the judgment which was clearly inconsistent with the general guidance on the application of GARs and terminal bonus, "albeit that the Equitable's GAR policyholders are effectively being charged for this option according to its value at the vesting date of the contract rather than over the duration of the contract, though there is nothing to indicate that another office might not operate some other fair basis of charging". GAD also noted that the Vice-Chancellor also seemed to endorse the regulator's stance on the need to reserve additional amounts for GARs.
- 4.45.2 On the following day GCD sent a five page note to IFSD and Michael Foot summarising the judgment. The note was also circulated to IBD and was subsequently sent to IB-PIA and Enforcement on 14 September 1999. The note referred to the Vice-Chancellor's reference to the concept of PRE and his statement that the statutory provisions: "recognise that policyholders may have a reasonable expectation of benefits over and above their contractually guaranteed benefits." GCD noted that this was very significant and was the first real judicial support which the regulator had had for this principle.
- 4.45.3 GCD referred to the issue of breach of contract and commented on the Vice-Chancellor's finding that there was nothing in the contract to prevent Equitable Life's terminal bonus practice:
- "This on its face seems right, but I understand that the FSA has some evidence that, on maturity and when options were being discussed with policyholders, the Equitable did not tell policyholders in terms that terminal bonus was conditional. This is not a matter for IFSD however and is before the PIA."
- 4.45.4 The Vice-Chancellor found that:
- "a reasonable expectation does not become a contractual right. PRE was no more than one of the factors to be taken into account by the Directors. Its effective weight in the balance would depend upon all other factors taken into account. And the balance was, and is, one for the Directors, and not the Court, to strike."
- 4.45.5 GCD went on to comment that the Vice-Chancellor found that GAR policyholders had a reasonable expectation that they would receive full terminal bonus with a GAR annuity and said:

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

4.45.6 The note continued:

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

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

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

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

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

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

4.45.9 On 16 September 1999 Equitable Life wrote to all policyholders setting out the positive approval the Society considered it had been given by the Court for its bonus practice. There is no evidence that the FSA saw this letter before it was sent out.

- 4.45.10 On the same day, the FSA Board held its regular monthly meeting. The written report to the Board had been prepared before the judgment had been given and therefore merely notified the Board that judgment was expected on 9 September and that the FSA would need to study the judgment and report again to the Board in due course. The Board was informed that the ruling might have wider consequences for the interpretation of PRE.
- 4.45.11 On 23 September 1999 IB-PIA completed its review of the bonus notices which IFSD had sent in June 1999 and advised IFSD that its initial view was that IB-PIA believed that it did not have jurisdiction to take any action in relation to bonus notices, but that in any event it did not consider the bonus notices to be poorly presented or inaccurate. IFSD described PIA's response as a "surprisingly unqualified endorsement" of the bonus notices, but did not revert to IB-PIA.
- 4.45.12 On 1 October 1999 GAD sent a memorandum to IFSD setting out why GAD considered that the judgment was more favourable to Equitable Life on the question of PRE than was implied by the GCD summary.
- 4.45.13 There remained small differences within IFSD and GAD about what the Vice-Chancellor had said about PRE and its potential impact, but since the whole issue was going to appeal it was not thought necessary to address these for the time being.
- 4.45.14 On 11 October 1999 there was a meeting between IFSD and IB-PIA at which IFSD reported that "Although the [First Instance] judgment was in favour of the Equitable, IFSD view [sic] is that although Equitable had regard to PRE they did not meet it so there is the possibility of intervention."

4.46 Initial risk assessment - August 1999

- 4.46.1 At the end of August 1999 IFSD prepared an Initial Risk Assessment of Equitable Life as part of piloting a new FSA assessment methodology. In interview we were told that this was part of a pilot for the introduction of risk assessment for all companies. It was produced for the supervisors to review the format and was based on information "to hand". The overall summary stated that Equitable Life was seen as a "high financial risk because of the level of benefits guaranteed to policyholders, the relatively low free asset position and the difficulty it would face in raising external finance. Equitable would be particularly vulnerable to a sustained and significant fall in equity prices."
- 4.46.2 Under the section headed "Cultural Attitude", were the following comments:
- "A tendency to arrogant superiority regarding the efficiency of their operations and the high priority given to the interests of policyholders. This can blind them to the financial risks that can arise as a result of guaranteeing high benefit levels."
- 4.46.3 We have been told that the reference to "high benefit levels" was a reference to the generous rates of reversionary bonus which Equitable Life paid to its policyholders, not to its GAO contracts.
- 4.46.4 It was noted below the heading "Corporate Governance" that there was no particular reason to believe there were problems in this area although little evidence was available. IFSD noted that the Board papers which it had seen relating to bonuses suggested that the Board was presented with the information which was necessary in order to make a decision. The note recorded that more information was needed about reporting lines into the Board and the frequency of Board meetings in order to be

able to assess the extent to which an appropriate degree of control was being exercised by the Board.

4.46.5 Under the heading “Internal Controls and Risk Management” IFSD noted that it required more information before it could form a judgement.

4.46.6 As far as solvency issues were concerned, IFSD noted that the relatively low free asset position together with Equitable Life’s mutual status (making the raising of external capital difficult) and the high levels of reversionary bonus which had traditionally been declared meant that the company was potentially highly vulnerable to a change in economic circumstances. A sustained period of low investment returns - particularly if it was associated with a substantial fall in equity prices - could be particularly damaging. It was noted that Equitable Life had taken heed of the regulator’s concerns about the level of reversionary bonuses and had made some effort to reduce them that year. Further reductions would be needed in future years if the risk was to be significantly reduced.

4.46.7 Below the heading “Financial” and the sub-heading “Reserving/Capital” it was noted:

“Equitable has a high exposure to guaranteed annuity options. It had to establish reserves for GAOs in excess of £1.5b in 1998 and it is arguable that a higher reserve should have been set. Approximately half the reserve is covered by a reinsurance arrangement. It is dependent on the reinsurance to be able to demonstrate a reasonably healthy level of free assets. Also potential risk that Equitable could need to pay compensation to GAO policyholders if it loses the current court case.”

4.46.8 In summary, the note recorded that more information was needed on internal controls and risk management and audit and compliance. This information, and more information about Board meetings and reporting lines, was sought by a letter dated 15 November 1999, in advance of the company visit which the FSA made to Equitable Life’s offices in Aylesbury in December 1999.

4.47 Reserving - late 1999

4.47.1 On 20 September 1999 there was an exchange of e-mails between IFSD and GAD concerning finalisation of GAD’s scrutiny of Equitable Life’s regulatory returns for 1998. GAD confirmed that the detailed scrutiny had been submitted to the FSA on 20 May 1999, but reminded IFSD that there were two outstanding matters: the further consideration of the final terms of the reinsurance agreement and a policy decision on whether to challenge some of the assumptions made in setting the reserves for GAOs. GAD asked whether the final wording of the reinsurance agreement had been received and noted that the dialogue on the second issue (reserving) was continuing and that no formal consideration had been given to the Appointed Actuary’s “observations” in his letter to GAD of 19 July 1999.

4.47.2 On 24 September 1999 GAD sent a memorandum to IFSD stating that GAD was not inclined to pursue the issue of the level of Equitable Life’s reserves for guaranteed annuities any further at this point even though GAD remained “somewhat uncomfortable that [the Appointed Actuary’s] assumptions are not fully in line with expectations based on our interpretation of the GA’s letter on this subject.” Since the reinsurance agreement provided protection for losses in excess of a 25% take-up rate for GAOs, any required increase in gross reserves arising from an amendment to Equitable Life’s assumptions as to take-up rate would be matched by an equivalent increase in reinsurance recoveries. There would therefore be no net effect on Equitable Life’s overall financial position. However, GAD suggested that the topic

could be raised at the forthcoming company visit and confirmed that detailed scrutiny of the 1998 regulatory returns was now considered to be closed.

- 4.47.3 The memorandum from GAD also stated that Equitable Life's calculations for its future profits implicit item requested by Equitable Life on 30 March 1999 were in line with the guidance but suggested that IFSD should ask the Appointed Actuary to certify that the amount used must not exceed the present value of future profits expected to emerge and that the Appointed Actuary would need to make allowance for the potential effect of the reinsurance agreement in reducing future profits. GAD also reminded IFSD that a copy of the reinsurance agreement as signed should be requested from Equitable Life.
- 4.47.4 Accordingly, on 28 September 1999 IFSD wrote to the Appointed Actuary confirming that before recommending Equitable Life's application for a future profits implicit item be approved, confirmation was required as to the effect the reinsurance agreement would have on future profits. IFSD also renewed the request for a copy of the final version of the reinsurance agreement.
- 4.47.5 The reinsurance agreement was signed by IERC on 30 September 1999 and by Equitable Life on 11 October 1999 and was sent to the FSA on 14 October 1999, together with a revised application for a future profits implicit item of £1billion. In the covering letter the Appointed Actuary confirmed that in making the calculations supporting the application he had not "double counted" future profits which might be required to make repayments to the reinsurer if claims arose under the reinsurance agreement.
- 4.47.6 On 22 October 1999 GAD sent a note to the FSA advising that Equitable Life's revised application for a future profits implicit item of £1000million was acceptable. On 8 November 1999 the ISC approved the application for the future profits implicit item, according to the minutes, "without further discussion" and on 9 November 1999 HMT issued the Section 68 Order granting formal approval.

4.48 Meeting attended by all regulators

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

4.49 Company visit

- 4.49.1 HMT-ID, and subsequently IFSD, sought to visit insurance companies once every three years, although the aim was to increase the frequency of visits. A company visit to Equitable Life had taken place in November 1996. In September 1999 IFSD arranged to visit Equitable Life on 6 December 1999. In advance of the visit, it had been agreed that its purpose was to talk about "the broader picture rather than just GAOs" and to discuss the Society's overall position and future plans to ensure that IFSD had a more rounded picture of the company's operations. On 15 November 1999 in preparation for the visit, IFSD requested a number of items of information from Equitable Life including the latest financial condition report, structure charts,

details of board sub-committees, copies of the latest business plans and papers on future strategy, details of investment policy, the latest report from the investment manager, the internal audit programme for 1998 and 1999 and internal audit's most recent report to the Board or to senior management.

- 4.49.2 On 25 November 1999 the Appointed Actuary sent IFSD a substantial volume of the background material which had been requested. That material included copies of reports to the Board of Equitable Life, financial projections and internal audit documents. In lieu of a financial condition report Equitable Life sent a copy of the latest set of financial projections dated 23 April 1999 (a copy of which had been sent to IFSD on 4 May 1999) and the latest report to the Board on revenue and solvency matters dated 22 October 1999.
- 4.49.3 The visit was referred to at a college meeting²⁵ on 26 November 1999, attended by, among others, IFSD and IB-PIA, at which various assurances as to information exchange were given by IFSD to IB-PIA, following IFSD's agreement to pilot lead supervision for various firms including Equitable Life in June 1999. IFSD explained that it would be visiting Equitable Life and that although the focus of its recent regulatory activity had been on solvency and the GAO issue, it was hoping to fill in some of the gaps in its knowledge of the Society as a result of the visit.
- 4.49.4 According to the note of the company visit by IFSD to Equitable Life, among the topics covered were:
- (a) overview of corporate management structure;
 - (b) general market outlook and business strategy;
 - (c) investment policy and asset management;
 - (d) systems and controls; and
 - (e) financial position/role of Appointed Actuary.
- 4.49.5 In the note of the visit, under the heading "Investment Policy and Asset Management" it is noted that GAD felt that "Chris Headdon's future projections ... did not fully take into account the scenario of a long term stock market depression - which could have severe implications for the Society".
- 4.49.6 As far as systems and controls were concerned, Equitable Life told IFSD that the Society had recently reviewed the control systems in conjunction with consultants. The consultants had concluded that Equitable Life's processes were satisfactory but could be improved if they were more formalised and had recommended that the Society considered creating a traditional internal audit function. The Board agreed to do so and were recruiting an internal auditor from outside Equitable Life. Equitable Life told the FSA that it expected that the new internal auditor and a new internal audit function would lead to a more structured formalised approach to risk management that would look across the business and not just be "top down."
- 4.49.7 The discussion about GAOs was limited. The Appointed Actuary told IFSD that the reinsurance agreement had been extended to cover group business whereas previously it had covered only individual business. This would improve the reported solvency. The gross GAO reserve was £1.56billion, this reduced to £760million net after the reinsurance. The extension to the reinsurance agreement to include group

²⁵ As explained in Chapter 2 and described in Chapter 5.

schemes had further reduced the net GAO exposure to £560million. The Appointed Actuary reported that next year all of these figures would further decrease since about 10% of GAO business would come off the books. There was also a short discussion about reserves and Equitable Life was warned that the FSA and the Government Actuary would be setting out more clearly the approach to be taken with respect to reserving for GAOs. This could mean that Equitable Life would have to increase its gross reserves for GAOs.

4.50 December 1999 guidance on reserving for GAOs

4.50.1 The guidance which had been issued in January 1999 requiring full reserves for GAOs had stated as follows:

“It is likely that close to 100% of policyholders will exercise the annuity guarantee unless the company maintains terminal bonus at a level which ensures that the value to the policyholder of the alternative benefit is at least equal to the value of the guaranteed annuity. Accordingly, this constraint will need to be reflected in the valuation assumptions made about either the proportion of policyholders opting for the alternative benefit or the value of that alternative benefit. Consequently any reduction in the reserves held by the insurer by more than a few percentage points below the full value of the guaranteed annuity for this reason would require very careful justification by the actuary.”

4.50.2 As GAD had noted in its scrutiny of Equitable Life’s 1998 regulatory returns, the Society had interpreted “a few percentage points below the full value of the guaranteed annuity” as about 80% of the full value. As part of the scrutiny exercise, GAD had asked Equitable Life how it had reached this figure but, as at 24 November 1999, had not expressed a view on the acceptability of Equitable Life’s argument on this point. In an e-mail of that date, IFSD noted that it had intended the phrase “a few percentage points below the full value of the guaranteed annuity” in the January 1999 guidance on reserving for GAOs to mean around 95% of the full value, in total.

4.50.3 The FSA was concerned that a number of companies had interpreted the guidance as meaning 10% and two companies had gone beyond this. As a result, IFSD considered it should set out for companies the intention of the guidance when it referred to “a few percentage points”.

4.50.4 Clarification of the guidance on reserving for GAOs was issued on 22 December 1999 in a letter from the Government Actuary. A copy of this guidance appears at **Appendix 3** to this Report. The letter was also sent to managing directors of all life insurance companies under cover of a letter from IFSD. The reference to “a few percentage points” was clarified to mean the total aggregate allowance that might prudently be made for all other benefit forms (whether cash or other forms of annuity) and that, in the FSA’s view, an allowance in excess of 5% would not be considered to represent “a few percentage points.” The Government Actuary explained that in his view:

“in determining the reserve for a contract containing a guaranteed annuity it would not generally be prudent to assume that policyholders will choose a benefit form that is of significantly lower nominal value to them than the guaranteed annuity. I indicated previously that I would expect any allowance for the reduction in the liability on the basis of policyholders making such choices to be limited to “a few percentage points” of the reserve. I would like to clarify that I was referring here to the total aggregate allowance that might prudently be made for all other benefit forms (whether cash or other forms of annuity) and that in my view an allowance in excess of 5% would not be considered to represent ‘a few percentage points’.”

4.50.5 The letter also reported that the Government Actuary was reviewing the level of disclosure of the assumptions made by each company in the 1998 regulatory returns.

4.51 Hearings in the Court of Appeal

4.51.1 As far as the Court case was concerned, on 21 October 1999, Michael Foot's report on recent developments within financial supervision was sent to the FSA Board noting the outcome of the First Instance hearing and stating that "The judgment is subject to appeal; we shall await the outcome of the appeal before considering whether any further action by FSA is called for."

4.51.2 On 28 October 1999 IFSD was informed by the Appointed Actuary that the appeal was listed to be heard at the end of November 1999. Equitable Life said that it would send the FSA copies of the skeleton arguments to be lodged by Mr Hyman.

4.51.3 Michael Foot's November report on developments within financial supervision was sent to the FSA Board on 18 November 1999 and reported that the Court had given permission to appeal to the representative policyholder in the Court case and that the hearing of the appeal had been set down for hearing in late November 1999.

4.51.4 The appeal hearing opened on 29 November 1999.

4.51.5 The Court of Appeal's judgment was given on 21 January 2000. By a majority of 2 to 1 the Court allowed the appeal of the representative policyholder. Lord Woolf MR, now Lord Chief Justice, gave the leading judgment. The following passage contains the essential reasons for his decision:

"[Equitable Life's directors' decision to adopt the terminal bonus practice] was an exercise of discretion reducing the policy-holder's reasonable expectation that he would receive his asset share irrespective of how he exercised his rights under the policy. The purposes for which the powers contained in Article 65 are conferred on the Society do not include treating a policy-holder differently depending on the manner in which he seeks to exercise his rights under the policy which he has been granted by the Society in return for his premium. This is precisely the result of the policy adopted by the Society and it is a collateral purpose designed to negative a benefit to which the policy-holder would otherwise be entitled."

4.51.6 Waller LJ, who also gave judgment in favour of Mr Hyman, held that on a proper construction of the policy Equitable Life had not been entitled to allot a final bonus which was conditional upon the form in which the benefits under the policy were taken. However, he commented at the end of his judgment (a comment which does not form part of his reasoned decision):

"It is possible that because there is no contractual entitlement to a final bonus, and because as between different types of policy it is certainly, in my view, legitimate for the Board to have regard to the value of the notional asset share of the different policyholders, the Guaranteed Annuity Rate policy-holders will not in actual cash terms do very much better than they have done under the differential bonus scheme. I see no reason why different bonuses may not be awarded to different types of policy-holder and thus I do not understand why, for example the Board cannot in deciding what final bonus to award to GAR policy-holders keep that bonus at a level which does not deprive different with profits policy-holders of their equivalent asset share. What the correct final bonus is in relation to GAR policies could only be worked out by the Board on the advice of the actuary."

4.51.7 The headnote to the Court of Appeal's judgment appears at **Appendix 5**.

4.52 Reactions to the Court of Appeal judgment

- 4.52.1 On 21 January 2000 Equitable Life sent a facsimile to IFSD, enclosing Equitable Life's solicitors' summary of the Court of Appeal's judgment. Based on the document prepared by Equitable Life's solicitors only, which IFSD had sent on to GAD, GAD sent its initial assessment of the judgment to IFSD on the same day. GAD's view was that most of the advice in the guidance issued by HMT-ID in December 1998 would still be relevant and that the judgment vindicated IFSD's stance on the reserving levels required. GAD also noted that it was not clear how the judgment was intended to be applied to Equitable Life's existing policies but suggested that the costs to the Society should be fairly marginal. It also suggested that Equitable Life be asked to confirm that the reinsurance agreement would be unaffected by the judgment.
- 4.52.2 Shortly after the judgment had been given, IFSD informed IB-PIA that it was no cause for panic; Equitable Life had been given permission to maintain its payment practice pending an appeal to the House of Lords; the financial position of the company was "largely unaltered by the judgment as Equitable Life already has to fully reserve in the Annual Returns for biting GAOs."
- 4.52.3 On 24 January 2000 Howard Davies asked IFSD whether there was any substance in the claim which he had seen in the press that "others in the industry think we have been indulgent towards the Equitable". The article, which appeared in *The Independent* on 22 January 2000, stated that: "Competitors said that the decision had taken not just the Society by surprise but also insurance regulators at the Financial Services Authority who are widely believed in the industry to have offered Equitable a high degree of latitude in dealing with the issue."
- 4.52.4 IFSD's response to Howard Davies was that no concern had been heard to that effect in the industry and that a number of companies, including Equitable Life, believed that the FSA had taken a very tough line on reserving standards in respect of GAOs. It was suggested that the comment by one of the Appeal Court Judges that the 1998 guidance letter to life offices "endorsed" Equitable Life's position may have been picked up by the press as an indication of "indulgence".
- 4.52.5 Following the judgment, on 24 January 2000, IFSD was requested to provide a summary of the general implications for the insurance industry for HMT. IFSD considered this might be premature because:
- "The company have been given leave to appeal. Even if the Court of Appeal's decision is upheld the implications, both for the Equitable and the industry will depend on the terms of the Lords judgment. As an instance of this, the implication of the CoA judgment seems to be that the Equitable is entitled to declare bonus on a differential basis as between policies with GAOs and those without, but not between policies with GAOs where the option is exercised and those where it is not. The House of Lords might, presumably reach a different view on this which could have implications for the company/industry which are different from, though of the same or greater order than, those which would flow if the CoA decision was not appealed."
- 4.52.6 In a memorandum dated 28 January 2000 prepared by IFSD and circulated internally, which stated that it had been prepared without considered legal advice, it was noted under the heading "Implications for the industry (if the judgment stands)":

“Equitable would need to revise its bonus policy for future years, but potentially the new approach need not lead to any significant additional costs for the company. The question of whether any compensation might be payable in respect of policies vesting in the last five years could only be assessed in the light of the HoL judgment. However our assessment remains that any compensation cost would be unlikely to have a material impact on the company’s financial position. The reputational damage to the company would only become apparent at a later date.”

4.52.7 On 31 January 2000 GCD circulated a summary of the Court of Appeal judgment to IFSD and GAD. The summary focused on the leading judgment because in GCD’s view “it was the most interesting” but GCD made it clear that for a non-lawyer the only matter of real interest was that each judge made his findings for different reasons. The summary quoted Lord Woolf’s reasons extensively. It referred to Lord Justice Waller’s judgment by simply stating that he:

“concluded that while different bonuses might be awarded to different types of policyholder (eg GAR policyholders), and the award of differential bonuses was within the wide discretion of the Directors, differential bonuses were not permissible under the terms of the policy.”

4.52.8 The note also stated:

“In the result, it is impossible to predict which way the House of Lords will jump. Much will depend on the panel which is selected to hear the appeal. It seems reasonably likely as well that the Judges on the panel (like those in the Court of Appeal) will have different reasons for their decision. Accordingly, any attempt to divine the implications of this judgment or to guess the contents of the decision of the House of Lords (apart from recognising that the Equitable might win or lose) would probably not be of much benefit. In addition neither the Vice-Chancellor nor the Court of Appeal dealt with mechanisms of compliance with its judgment (partly because argument was not made on this issue and partly because they might in any event be agreed by the parties, hopefully in consultation with the FSA). If the Court of Appeal is upheld, how compliance is or may be achieved by the Equitable (there may be more than one way) could significantly affect any implications for ‘the industry’.”

4.52.9 This summary was interpreted by Michael Foot as meaning that the House of Lords would either “jump” to the Court of Appeal decision (meaning the *obiter* comment of Lord Justice Waller) or to the decision of the Vice-Chancellor at first instance, not to what he saw as “an extreme third option”. In interview IFSD said “I think we felt after the Court of Appeal that we were entitled to take a reasonable assessment of what the worst likely outcome was, as being effectively the Waller outcome”.

4.53 Letter from Equitable Life to policyholders following the Court of Appeal decision

4.53.1 On 1 February 2000 the Equitable Life wrote to all policyholders updating them on the latest situation in respect of the Court case. The letter stated:

“Contrary to many of the reports which have appeared in the press, there would be no significant costs imposed on the Society if the Court of Appeal’s decision were upheld in the House of Lords. The speculation regarding financial difficulties and costs to be borne by with-profits policyholders is therefore unfounded. Your Society remains, and will continue to remain, financially secure.”

- 4.53.2 A copy of the letter was given to IFSD by an employee of the FSA who was an Equitable Life policyholder. The letter was only seen by the FSA after it was sent out by Equitable Life. It was not forwarded by IFSD to IB-PIA.
- 4.53.3 On 17 February 2000 the FSA Board was updated on recent developments within financial supervision. The report stated as follows:
- “Equitable does not appear to face any immediate financial risk or any additional threat to its independence. If the appeal judgment was upheld, Equitable would need to revise its bonus policy, but potentially the new approach need not lead to significant additional costs. The reputational damage from the court case will only become apparent at a later date, but interestingly the judgment did not spark a significant surge in calls to the company’s policyholder helpline.”
- 4.53.4 On 2 March 2000 GCD sent an e-mail to one IFSD executive querying whether there was an argument that to impose the costs of the guarantees only on GAO policyholders “would be [a] breach of PRE and might fall foul” of the judgment of Lord Woolf in the Court of Appeal.
- 4.53.5 From the documents seen by the Review Team, there was no communication between IFSD and Equitable Life between mid-January 2000 and late May 2000 relating to the Court case, save for the summary of the judgment prepared by Equitable Life’s lawyers which was sent by facsimile to IFSD on the day of the Court of Appeal judgment.

4.54 Meeting between IFSD and Enforcement

- 4.54.1 On 8 March 2000 IFSD had a meeting with Enforcement relating to PFWs. IFSD was concerned about any impact on Equitable Life’s solvency which might result from Enforcement’s activities. This is referred to in **Chapter 5**.

4.55 House of Lords hearing - June 2000

- 4.55.1 On 31 May 2000 IFSD received copies of the Agreed Statement of Facts and Issues and the document setting out Equitable Life’s Case for the House of Lords hearing which was due to take place on 12 June 2000. IFSD circulated copies of those documents to GAD and GCD. Equitable Life’s lawyers said that they were unable to obtain consent from Mr Hyman’s lawyers to release a copy of his Case for the House of Lords. IFSD noted that it was not intending to request a copy of Mr Hyman’s Case for the House of Lords because it did not wish to suggest or to create an expectation that the FSA “would/could do something depending on the outcome of the case.”
- 4.55.2 On 12 June 2000 the hearing of the case of *Equitable Life v Hyman* commenced in the House of Lords. The hearing lasted for four days. Copies of the transcripts were sent to the FSA, although it is not clear on what date they were received.
- 4.55.3 Shortly after the House of Lords’ hearing, on 27 June 2000, Equitable Life made an application for a future profits implicit item of £1.1billion for use in its year end regulatory returns. The regulatory returns for year end 31 December 1999 were received by IFSD on 30 June 2000. On 7 July 2000 GAD recommended to IFSD the granting of the future profits implicit item. GAD stated “We have reviewed the Actuary’s calculations in the light of the 1999 returns and are satisfied that they are consistent with the relevant Regulations and Guidance Note.” GAD noted, amongst other things, that there was a significant margin between the £1.1billion amount applied for and the maximum £3.3billion amount that the company could have applied for based on the information provided. GAD concluded “We therefore

recommend that FSA grant their consent for the society to use an implicit item of £1.1bn in their 2000 FSA Returns.” The application was considered by the ISC in September 2000 and is referred to in more detail in Part 3 below.

4.55.4 On 4 July 2000 Michael Foot received a call from Equitable Life. Equitable Life informed Michael Foot that the Equitable Life Board was considering what ought to be done if Equitable Life lost in the House of Lords. Although Equitable Life had no firm idea of the likely judgment, Michael Foot was told that there were “straws in the wind” that the House of Lords would “like to find against the Society.”

4.55.5 Equitable Life wanted to see what thoughts the FSA had about whether it was necessary for there to be resignations at a senior level in the event of such a Court decision. Michael Foot sent a note of the telephone conversation to Howard Davies, with a single copy to IFSD suggesting that the FSA should emphasise the importance of retaining an adequate executive relationship and that it depended on the presence or absence of detailed criticism in the judgment.

4.55.6 On 5 July 2000 Michael Foot recorded in a note to Howard Davies (a single copy of which was sent to IFSD) that he had told Equitable Life that the FSA wished to ensure continuity amongst the executives at Equitable Life and suggested that any resignations could take place at the year end. He also said that it depended on the judgment, but “on what we knew so far it was unlikely that the FSA would be throwing brickbats at Equitable Life.”

4.55.7 A meeting between Equitable Life and IFSD took place at Equitable Life’s request on 18 July 2000. The meeting was to discuss contingency planning for the House of Lords’ judgment which was due to be given on 20 July 2000.

4.55.8 The note of the meeting does not refer to the telephone call from Equitable Life on 4 July 2000, although it does refer to new arguments raised in the House of Lords. The meeting note records that the possibility of losing in the House of Lords “was thought unlikely” but if it did, on the basis of scenario 3, set out below, it would have severe consequences for the Society. Equitable Life outlined three scenarios. The third (a ruling which required Equitable Life to pay GARs on top of full terminal bonus) is stated in the meeting note not to have been seen as a potential option before but followed arguments which the House of Lords had heard. The note also recorded that Equitable Life considered that this new third scenario was now in play:

“A ruling that did not allow the Society to alter the rate of bonus for policies that contain GARs - the Society would need to declare a rate of bonus as if the policies did not contain GARs. This would mean that the Equitable would have to pay a GA on top of unadjusted asset share; the directors of the Society would not be able to adjust bonus rates downwards because GAR benefits gave an additional benefit to the policyholder.”

4.55.9 Although this outcome was still considered unlikely, if Equitable Life had to pay GARs on top of the value of unadjusted asset share, it would have a profound effect on solvency. The reinsurance agreement would no longer be valid and Equitable Life would need to find assets to fund the additional benefits payable to GAR policyholders from its own resources. It was estimated that this could be in the region of £1billion to £1.5billion depending on the precise nature of the judgment. The note records that the reinsurance would remain in effect for 3 months covering policies vesting during that 3 month period, but would not protect Equitable Life’s

balance sheet position for all the relevant GAO policies²⁶. The note recorded that Equitable Life “had not sought to renegotiate [the] treaty to cover the Society’s GAR liability if this scenario occurred. The Appointed Actuary did not think this was likely to be a viable proposition in any case.”

4.55.10 The meeting note records that Equitable Life told IFSD that it would need to find the assets for funding the additional benefits from its own resources. Equitable Life proposed to announce immediately that it would seek a partner if this third scenario occurred. Equitable Life “was keen to avoid any precipitous action from the FSA in the light of this adverse judgment. Mainly because this could have a detrimental effect on the value of the business, for example stopping the company writing new business could lead to losses in the field force and this was a valuable asset for the Society.”

4.55.11 IFSD indicated that it would not “rush to take remedial action in these circumstances and understood the importance of maintaining the value of the society.” The FSA would however need to be convinced that there was a prospect of a suitable buyer being found quickly. This approach was based on IFSD’s view that there was no reason to take any hasty regulatory action in circumstances where a solvent firm was seeking to put itself up for sale and any such action would be carefully considered, including the impact of such action on the interests of policyholders.

4.55.12 The Appointed Actuary reported that he was conducting some scenario modelling to see if the company would be insolvent if scenario 3 occurred and GAD asked to receive these details when complete, which it was told would be the following week.

4.55.13 The Appointed Actuary said that if the House of Lords upheld the Court of Appeal judgment, Equitable Life expected to reduce the bonuses of GAR policyholders as a class. On 2 March 2000 GCD had queried whether this might “fall foul” of Lord Woolf’s judgment. The meeting note recorded that:

“If the Lords basically upheld the Court of Appeal judgment this would prohibit the Society from paying differential bonus levels according to the form of benefit that a GAR policyholder takes. However, the Society believed it would then be within its rights to offer a reduced rate of bonus for all GAR policies whether or not the policyholder elected to take the open market option. In these circumstances as things stood GAR policyholders would get a larger slice of the pot for this class of policyholders. (Although this pot would be smaller since the Society would have dropped bonus rates and would leave the Society open to criticism from aggrieved GAR policyholders that having won the argument they are no better off). It could also lead to arguments that the Society has ignored the spirit of the Lords judgment.”

4.55.14 On 19 July 2000 an internal note was prepared by IFSD setting out the possible outcomes of the House of Lords case, taking account of Equitable Life’s views which had been expressed at the meeting on the previous day, and the regulatory action that was likely to be appropriate in each case. It was circulated to Howard Davies, Michael Foot and IFSD. It was not sent to IB-PIA. We have subsequently been told that this was because it was circulated on a “need to know” basis. In the introductory section the note states as follows:

“It should be noted that Option 3 is not something that has been considered previously. It would involve the court opining on the apportionment of bonuses

²⁶ The agreement was terminable on 3 months’ notice given by Equitable Life. In the event of a change in Equitable Life’s terminal bonus practice, no further claims would be possible and the agreement would be terminated.

between different classes of policyholders (GAR and non-GAR policyholders) rather than just on the bonus entitlements of GAR policyholders. Previous court hearings focussed on the narrow issue of the rights of GAR policyholders. However, the hearings in the House of Lords suggest they may consider the issue in its broader context. Although Option 3 now appears to be a possibility, we still consider it much less likely than the other two potential outcomes.

As indicated below the implications of Option 3 would be much more serious for Equitable, and potentially have much wider implications for the industry and the FSA.”

4.55.15 The three broad scenarios were:

- 1 “Equitable Life win” - different levels of terminal bonus may be paid to policyholders depending on whether they exercise their right to take an annuity at guaranteed rates.
- 2 “Equitable Life lose” - different levels of terminal bonus may not be paid according to whether a policyholder opts to take advantage of his guaranteed annuity rate but a guaranteed annuity rate policyholder need not receive the same level of bonus as a policyholder whose contract does not include a GAR.
- 3 “Equitable lose very badly” - different levels of terminal bonus may not be paid and the existence of GARs in a class of contract should not influence the level of bonuses paid to that class of contract.

4.55.16 The implications of Scenario 3 for Equitable Life were set out as follows:

“The judgment would require the company to declare one level of terminal bonus, effectively at the higher of the two levels currently available. This would lead to a substantial increase in costs in honouring the GARs and also raise the issue of compensation for policyholders who have already taken their retirement benefits. The compensation costs would be relatively modest (estimated at up to £200m) but the overall financial implications of the judgment would be very serious. The reinsurance treaty put in place to cover some £1billion of the reserving costs of the GARs would fall away (it is conditional on Equitable maintaining its current bonus practice or something equivalent in cost terms). This would have knock on effects elsewhere in its reserving and Equitable estimates that it would only just be able to cover its solvency margin (year end position was assets of £3.8b to cover a solvency margin of £1.1b).

In this scenario, Equitable could adjust its investment portfolio (match its assets and liabilities more closely) in order to improve its statutory solvency position. However, this could be expected to reduce the investment return to policyholders and the resulting financial position would still not be expected to be sufficiently strong for market confidence in the company to be maintained. Therefore Equitable’s board has reached the view that in these circumstances they should seek a partner as this would be the approach that was in the best interests of their policyholders. It is expected that there would be no shortage of potential partners.”

4.55.17 The implications of Scenario 3 for the FSA were also set out. These included keeping closely in touch with Equitable Life over its financial position and plans to sell. The note also commented that in the event that its solvency margin was breached, it was “unlikely FSA would need to take any public regulatory action since the company would already be taking steps to ensure its financial position was

repaired.” IFSD noted that it would need to discuss with Equitable Life compensation arrangements for policies which had vested and that IFSD would need to consider the wider implications of the judgment.

4.55.18 GAD was not asked to carry out any financial assessment of the implications of Scenario 3.

4.55.19 On 20 July 2000 the House of Lords handed down its judgment. The unanimous decision went against Equitable Life’s practice of differential terminal bonuses and ruled out the possibility of any lawful “ring fencing” by Equitable Life, such as by paying lower bonuses to GAR policyholders as a class. Within hours, Equitable Life issued a press release saying that its Board had concluded that members’ interests would be best served by:

“the sale of the business to an organisation capable of providing capital support and therefore ensuring continued investment freedom. The proceeds of sale to such a parent will mitigate the reduction in benefits that with profits policyholders not taking GAR benefits would otherwise suffer.”

4.55.20 When asked in interview whether Equitable Life should have been allowed to continue to write business after the House of Lords’ judgment, Howard Davies told us:

“we thought that was likely to produce the best outcome for policyholders, in that closing it to new business at the time would have significantly reduced the value of the company and would have significantly reduced the likelihood of a successful sale, which filled the hole.”

4.55.21 Howard Davies also told us in interview (and we believe that he is referring to meetings on 20 July 2000):

“I can’t say that there was a lengthy meeting on the subject. But there were a lot of ... corridor discussions at the time because this was a pretty chaotic day because it happened to be our annual meeting. I can remember asking whether we were really confident there were going to be lots of bidders, and at that time we were so confident, and therefore the issue of closure did not seem to be a very likely option to address. I can’t say that there was a lengthy consideration of this, but given the promptness of Equitable’s response to put themselves up for sale, that, we felt, sort of held the position ... I think if they had shilly shallied about the future, we would have had time to consider the options much more carefully at that time. But we didn’t really.”

4.55.22 The headnote to the House of Lords’ judgment appears at **Appendix 6**. The reactions to the judgment and the events which followed it are set out in **Part 3** below.

Part 3

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

4.56 Introduction

- 4.56.1 The House of Lords decided unanimously against Equitable Life in a judgment which was handed down on 20 July 2000. The House of Lords held that Equitable Life was in breach of contract because the general discretion in Article 65 of its Articles of Association was not sufficiently wide to permit the adjustment of policy values. Lord Steyn, whose decision and reasons the other four Judges agreed with, said that his decision was in substantial agreement with Lord Woolf. Lord Woolf had given the leading judgment in the Court of Appeal, in which he found against Equitable Life both in contract and in relation to directors' discretion.
- 4.56.2 Following the judgment in the House of Lords, six main issues arose which are dealt with in the sections which follow:
- (a) The immediate impact of the judgment;
 - (b) Amending the reinsurance agreement;
 - (c) Monitoring the solvency of Equitable Life;
 - (d) The bid process;
 - (e) Compensation; and
 - (f) Closure to new business.

4.57 Immediate impact of the judgment

- 4.57.1 A brief summary of the judgment was circulated by GCD on 20 July 2000, followed by a longer summary on the next day.
- 4.57.2 The longer summary prepared by GCD identified the main issue, namely, whether the Society was entitled to declare a differential terminal bonus because current annuity rates had fallen below GARs. The critical question in the absence of any express provision was whether it was appropriate to imply any restriction in the exercise of the directors' discretion from the language of Article 65 read in its particular commercial setting:

“The Court noted that final bonuses are not bounty. They are a significant part of the consideration for the premiums paid. The directors' discretion as to the amount and distribution of bonuses was conferred for the benefit of the policyholders. In this context the self-evident commercial object of the inclusion of guaranteed rates in the policy is to protect the policyholder against a fall in market annuity rates by ensuring that if the fall occurs he or she will be better off than would have been the case with market rates. The provision for guaranteed annuity rates was a good selling point in the marketing by the Society of the GAR policies. It was also obvious that it would have been a significant attraction for purchasers of GAR policies. The supposition of the parties was therefore presumed to have been that the directors would not exercise their discretion in conflict with contractual rights. An implication

precluding the use of the directors' discretion in this way is strictly necessary. The implication is essential to give effect to the reasonable expectations of the parties."

- 4.57.3 GCD's note included reference to Lord Justice Waller's suggestion in the Court of Appeal that the Society could lawfully have declared a differential terminal bonus which varied according to whether or not the policy included a GAR. The note also pointed out that Lord Steyn in the House of Lords took the view that the route suggested by Lord Justice Waller was not open to Equitable Life and its directors could not declare a differential terminal bonus to GAR policyholders because to do so would be to erode the value of the guarantee by another means.
- 4.57.4 GCD's summary concluded that while it was the worst possible outcome for Equitable Life, it was by no means clear what its wider implications would be for other companies with GAOs. It was recognised that the HMT-ID guidance letter of 18 December 1998 would need to be amended in the light of the House of Lords' judgment "to make its tone less positive [but] it is not yet clear whether it will require substantial amendment."
- 4.57.5 On 20 July 2000 IFSD spoke to the Appointed Actuary who said that he would try to send a rough calculation of the statutory solvency position in the next couple of days. The Appointed Actuary also warned IFSD that Equitable Life planned an immediate across the board cut in with-profits policy values of 5%. The Appointed Actuary said that the intention was that once a sale had been completed and bonus levels restored, those policyholders whose policies had matured in the intervening period would be eligible for a top-up "so nobody should lose out irrespective of when they took their benefits". According to the documents, IFSD did not comment on this decision. We have been told by IFSD that it now thinks the decision was taken in order to manage policyholders' expectations: "The company wanted to show a cost to policyholders arising from the judgment in order that they could subsequently show that same cost being met out of the proceeds of the expected sale."
- 4.57.6 On 24 July 2000 an action plan was circulated internally within IFSD and to GCD and GAD (but not to IB-PIA) for dealing with the judgment. The action plan included the points set out below:
- (a) Obtaining confirmation about the solvency position of the Society and reviewing its financial projections of future solvency (it was noted that the Appointed Actuary had confirmed "that he has no reason to believe that the company is in breach of its solvency margin", however, IFSD commented in the note, "the financial position is tight").
 - (b) Considering the implications of the judgment for other companies by writing to them and asking for their assessment of the implications of the judgment for their business.
 - (c) Reviewing the 1998 guidance issued to firms by HMT-ID.
 - (d) Arranging discussions with Equitable Life about the bid process and the regulatory issues that might arise.
- 4.57.7 Under the heading "sales process" it was noted that IFSD intended to hold a meeting with Equitable Life to "encourage it to maintain a close dialogue with us and to highlight the regulatory processes that will need to run alongside the sale/demutualisation".

- 4.57.8 IFSD decided that while the 1998 guidance letter was subject to review, life companies should be told not to rely on it. By letters dated 27 July 2000 IFSD wrote to managing directors of with-profits offices asking for their assessment of the implications of the House of Lords' judgment for their firm.
- 4.57.9 On 26 July 2000 Equitable Life announced changes to its bonus rates in response to the House of Lords' judgment. With-profits policies would be credited with no growth for the first seven months of the year but the previous growth rates would apply from 31 July 2000. Arrangements would be put in place to compensate those with GAR policies that had already matured. Equitable Life also stated that in selecting a purchaser it would be looking to obtain the maximum benefit for policyholders, and in particular to secure funds so that the lost growth for the first part of the year could be replaced.
- 4.57.10 On 2 August 2000 Equitable Life wrote to all policyholders explaining the implications of the House of Lords' judgment and explaining the change to bonus rates set out in its 26 July 2000 announcement.
- 4.57.11 Shortly after the House of Lords' judgment internal consideration was given as to whether or not to revise the guidance which had been issued in 1998 regarding charging for the costs of GAOs. The proposed new guidance was the matter of extensive internal consultation and a seminar was arranged and was attended by various external specialists to discuss the implications of the House of Lords' judgment for the preparation of any future guidance. GCD provided advice, counselling IFSD to be clear not to confuse or "conflate" the impact of the decision in the case with PRE:
- "These two are clearly different. The case is about giving effect to the rights of a policyholder against its insurance company. It is about the nature of the bargain between the company and the policyholder, with unstated parts filled in by what the court concludes must have been the shared mutual expectation of the parties.
- In contrast to this, there is the concept of 'policyholders reasonable expectations'. This is a power given to us, rather than to every policyholder. It is exercised like any other discretionary power on the basis of a range of considerations, including the seriousness of the conduct concerned, likelihood of its repetition, and so on."
- 4.57.12 External Counsel was also consulted regarding the drafting of proposed revised guidance. In the event, no revised guidance was issued because the FSA ultimately took the view that there were two possible dangers in issuing it: either it would be "content-free" or it risked judging the circumstances of individual contracts in a way which the FSA could not be certain was correct.
- 4.57.13 As far as briefing IB-PIA following the House of Lords' judgment was concerned, at a bilateral meeting between IB-PIA and IFSD on 24 August 2000, IFSD reported that the House of Lords' judgment against Equitable Life would have implications for the industry more widely, that the process of finding a buyer for Equitable Life was underway and it was hoped that a buyer would be identified by December 2000, with demutualisation taking place in August 2001. IFSD also told IB-PIA that, in the meantime, Equitable Life was just covering its solvency margin. This meeting is referred to in more detail in **Chapter 5**.

4.58 Amending the reinsurance agreement

- 4.58.1 As a consequence of the House of Lords' judgment, Equitable Life was required to re-negotiate the reinsurance agreement. As explained earlier, the reinsurance was conditional on Equitable Life continuing its terminal bonus practice. The House of Lords' judgment required Equitable Life to change its bonus practice and accordingly reinsurance on new terms had to be negotiated.
- 4.58.2 Without the reinsurance agreement, as far as the statutory financial position was concerned, IFSD believed that Equitable Life continued to cover its RMM.
- 4.58.3 Equitable Life updated IFSD by letter on 4 August 2000 confirming that the negotiations for an amended reinsurance agreement were going well. At a meeting on 11 August 2000 Equitable Life confirmed that a revised reinsurance agreement had been negotiated with IERC assuming a greater level of anticipated GAR take-up. This was close to completion and gave cover when over 60% of policyholders chose to take the GAR. The total annual deposit premium would be £700,000. In a letter dated 1 September 2000 Equitable Life sent to IFSD copies of the signed addenda to the reinsurance agreement. These were reviewed and approved by GAD on 22 September 2000.

4.59 Monitoring the solvency of Equitable Life

- 4.59.1 As set out in **Chapter 3**, there had also been changes in the valuation regulations which affected Equitable Life in the course of 2000 and required certain insurance companies to increase their reserves. The FSA believed that the resulting increase in reserves required by Equitable Life was in the region of £200-400million. In addition, during 2000, the Government Actuary updated his recommendations regarding the resilience test in the reserves.²⁷
- 4.59.2 On 26 July 2000 the Appointed Actuary wrote to IFSD as had been requested immediately following the judgment, setting out Equitable Life's estimated solvency position following the House of Lords' judgment. Based on the application of "old resilience test 2"²⁸ the Society had free assets of £225million. The Appointed Actuary stated:
- "On a continuing basis the position would be unacceptably weak. However, as you said last week, we have effectively implemented a plan to strengthen the position by taking the course of action which we have. Meanwhile I believe it is reasonable to regard the Society as continuing to meet its required minimum margin."
- 4.59.3 On 4 August 2000 the Appointed Actuary wrote to IFSD with information on the impact of new business on the solvency position of Equitable Life. He reminded IFSD that in his letter of 26 July 2000 excess assets as at the end of June 2000 were shown to be £225million. The equivalent figure at the year end, based on various assumptions including an assumption of no new business, would be £200million and including new business would be £210million. These figures did not take credit for the revised reinsurance agreement which was then being negotiated. The letter projected an improvement in solvency with the passage of time assuming reasonably favourable investment conditions.
- 4.59.4 On 4 August 2000, the Appointed Actuary wrote a separate letter to IFSD commenting on the effect of the recent changes in the resilience test (Test 2), which

²⁷ See **Chapter 3**.

²⁸ See **Chapter 3**.

he considered to be more stringent than the old version and noting that he would be sending some short-term projections incorporating new business.

- 4.59.5 At a meeting between Equitable Life and IFSD, also attended by GAD, on 11 August 2000, primarily to discuss regulatory aspects of the bid process, and described in more detail below, a number of other matters arose. There was a discussion about the charges to policyholders for transferring their pensions out of Equitable Life's with-profits fund and the possibility of hedging the GAO exposure. In addition, there was some discussion of the compensation arrangements which Equitable Life was putting in place.
- 4.59.6 At the meeting Equitable Life agreed to provide IFSD with monthly solvency figures, solvency scenario planning and sensitivity information regarding the possible 2000 and 2001 year end financial positions. Between July and the end of the Review Period, Equitable Life's monthly solvency position was monitored by GAD.
- 4.59.7 On 1 September 2000 a paper was prepared by IFSD for the ISC to assist them in deciding whether or not to grant Equitable Life a future profits implicit item of £1.1billion for use in its year end 2000 accounts. The Appointed Actuary had first made the application for this item on 27 June 2000 and GAD had, on 7 July 2000 (before the House of Lords' judgment), recommended that it be granted. The paper for the ISC set out the particular circumstances of Equitable Life and noted that the Society had lost its case in the House of Lords, which had led to "significant financial costs for the society." It noted that Equitable Life was still solvent but had been "weakened to the extent that the directors have decided that in the interests of policyholders it should seek a buyer to strengthen its financial position." The briefing for the ISC also stated "we have routinely given Section 68 Orders to companies for future profit implicit items provided that we have been satisfied that the basis of calculation provided for in Regulation 24²⁹ has been correctly carried out." It was noted that, based on Equitable Life's calculations, the application was for one-third of the amount of the total implicit items to which the Society was entitled and the solvency position of Equitable Life at the end of June 2000 was set out, expressed to be "re-stated post judgment":

Net explicit assets	£1580million
Current future profits item	<u>£1000million</u>
Total assets to meet RMM	£2580million
RMM	<u>£1190million</u>
Excess Assets	<u>£1390million</u>

- 4.59.8 The source of these numbers is not given but is most likely to be the Appointed Actuary's updated monthly solvency statement provided at the meeting with IFSD on 11 August 2000. The figures set out above were based on the new reinsurance agreement and on the 'old resilience test'. If the figures had been adjusted to the new resilience test the net explicit assets would be reduced by some £600million, as noted by the Appointed Actuary in the meeting of 11 August 2000. This would have led to Equitable Life showing significantly lower excess assets.

²⁹ Of the 1994 Regulations

- 4.59.9 The paper noted that “Equitable is unlikely to be dependent on the implicit item for coverage of its RMM” and “we would expect the company’s financial position to improve during the rest of the year (as profits emerge).”
- 4.59.10 The paper warned that “in the particular circumstances faced by Equitable it is important to carefully consider any request from this company that affects the form 9 position.” It also stated that “whilst there are a number of uncertainties that could affect the balance sheet (such as a reduction in long-term interest rates) these should not significantly affect the future profits calculation.”
- 4.59.11 The paper also noted that “the Society have provided the detailed calculations in relation to Regulation 24, these have been reviewed and approved by GAD who are fully aware of the context in which this concession would be granted.” The note does not record that, in fact, GAD’s opinion was prepared on 7 July 2000, before the House of Lords’ judgment.
- 4.59.12 On 11 September 2000, the day of the ISC meeting, the chairman of the ISC sent an e-mail to the ISC members stating that he had “not had time to put questions to individual supervisors bilaterally; but subject to the comments below, it may be that we will not need a meeting.” Regarding Equitable Life’s application, he stated that it “involves a fairly standard request for a concession for a future profits item.” He referred to the paper prepared by IFSD stating that it “makes clear that the Equitable’s request is well within normal parameters” and, as a result, he did not think there was any difficulty with the ISC agreeing to the recommendation. He then went on to state that “nevertheless, this implicit item is an important aspect of the Equitable’s overall financial position, and given the high profile of this company at present, some members may wish to discuss the paper.” He asked that members let him know by noon that day if they would like a discussion.
- 4.59.13 One member of ISC responded to the chairman’s e-mail, noting two points but stating that neither of them “would suggest that agreement should be withheld.”
- 4.59.14 The ISC approved the request on 11 September 2000 without meeting.
- 4.59.15 In interview, IFSD explained the role and involvement of the ISC in this application for a future profits implicit item as follows:
- “I think it is fair to say that the full background, in the way that we have just discussed it, was not set out. It will of course have been very much in the supervisor’s mind and the GAD’s mind. It may be a weakness of the way the ISC operates at the moment; that sometimes the narrow issue, which requires the formal approval is focused on. It is a matter of judgement ... there is a balance to be struck between how much paper you put before the committee and how much detail you go into. And on the whole, the committee bridles if the papers are too long. However, I accept that if the ISC is the only, as it were, decision maker, then it should have a rounded picture put to it, and basically that is what we tried to do. It may be that in this instance ... that it was fair, but it didn’t necessarily tell the wider picture that you have outlined. However, don’t forget that the Equitable was already a case which everyone up the hierarchy in the FSA, was taking a close interest in, so although this was a technical issue, the wider issues were already under scrutiny by Michael Foot and others. So to that extent, the ISC was only a cog in the wheel, and I think what I would say in, as it were, in defence of what we did, having accepted we might have done it better, is that that is how we saw the ISC.”
- 4.59.16 When asked in interview whether GAD looked at the wider circumstances of a company applying for implicit items, GAD said that it did not “think that that there

would be any sort of basis for us to advise that an application, that met with the relevant guidance and regulations, shouldn't be accepted.”

- 4.59.17 On 12 September 2000 a letter was sent to the Appointed Actuary granting the approval of the application. The letter commented that “the amount of the implicit item actually shown in Form 9 of the 31 December 2000 Annual Return cannot exceed the amount that could be supported by a new application submitted with that return (bringing in the financial performance of the company in 2000).” The letter made a second point that “if the society does demutualise, the company to which the business is transferred would not be able to take advantage of the surplus that has arisen in the Equitable in earlier years to generate an implicit item for itself.”
- 4.59.18 The Appointed Actuary wrote to IFSD on 1 September 2000 with a monthly solvency update to 31 July 2000 showing excess assets of £1300million.
- 4.59.19 On 21 September 2000 Michael Foot produced a note to the FSA Board to update them on recent developments within financial supervision. The Board was informed about the House of Lords’ judgment and, in particular, that “ring fencing” had been ruled out, that reports to the FSA from industry showed considerable uncertainty and confusion as to how it should respond and that the FSA planned to issue guidance to the industry, after consultation.
- 4.59.20 GAD confirmed to IFSD on 22 September 2000 that, although the solvency cover remained thin, it had no questions to raise at that time with Equitable Life about its solvency position.
- 4.59.21 On 9 October 2000 the Appointed Actuary wrote to IFSD providing an estimated solvency position as at 31 August 2000 showing excess assets of £2165million (an improvement which the Appointed Actuary explained by reference to relative strength of the markets) and some sensitivity analysis of the solvency to equity and gilt yield movements.
- 4.59.22 Following a review of the Appointed Actuary’s letter of 9 October, GAD sent a memorandum to IFSD on 17 October 2000 noting that a 15% fall in equities would lead to the RMM being uncovered. GAD pointed out that this corresponded to a fall in the FTSE 100 index to around 5700, from the end of August level of 6672. Since the index had recently been around 6200, GAD reminded IFSD that this needed close monitoring.
- 4.59.23 The Appointed Actuary wrote to IFSD on 30 October 2000 enclosing the end September solvency figures. He stated that they were broadly comparable with the June and July position. Excess assets were shown as £1140million (the end June excess assets were shown as £1390million).
- 4.59.24 On 31 October 2000 the FSA was informed by one potential bidder about concerns that GAR policyholders could pay incremental premiums into the fund to which the guarantee would attach, thereby increasing the fund’s liabilities to the detriment of non-GAR policyholders. By an e-mail dated 2 November 2000 from GAD to IFSD, the suggestion was raised that IFSD might issue an order preventing Equitable Life from accepting more than a specified sum of incremental premiums on GAO policies. GAD also suggested that Equitable Life could possibly seek a court order to limit the liability on such policies. IFSD subsequently found out that Equitable Life had received legal advice that it could not seek to limit top-ups by invoking an apparent right in the contracts to change the terms of the contracts if no premium was paid in any one year and IFSD obtained internal legal advice from GCD along similar lines.

4.59.25 On 3 November 2000 a meeting between Equitable Life and its advisers and IFSD and GAD took place at the request of IFSD and GAD to discuss reserving issues. The points arising at this meeting, according to IFSD's note, included those set out below:

- (a) Equitable Life was close to finalising a rectification scheme "allowing relevant GAR policyholders from 1 January 1994 to this year the ability to re-choose a scheme based on a higher level of GAO."
- (b) Equitable Life explained that Ernst & Young, who were assisting the Society in the bid process had "confirmed that [Ernst & Young] had looked at the sensitivities involved concerning the likelihood of GAR policyholders increasing their benefits and felt comfortable with Equitable Life's figures. [Ernst & Young] understood why potential purchasers would be worried by this potential exposure but thought that once the basis for the reserving was further explained some re-assurance had been given to bidders." This issue, which had been raised with the FSA by one bidder as a real concern, a few days before the meeting, is dealt with in the bid process section below.
- (c) IFSD requested greater involvement in the bid process and a copy of the Ernst & Young valuation report. The FSA had already seen reference to this report in a letter sent to them by Equitable Life on 1 September 2000 and had heard of the existence of this report from bidders in the bid process. Copies of three reports prepared by Ernst & Young were received by the FSA on 16 November 2000. The first report from Ernst & Young had been prepared on 25 August 2000. The contents of the reports is described in more detail below.
- (d) The Appointed Actuary said he was not aware of any concerns about reserving issues being raised by any of the bidders.

4.59.26 GAD also prepared a note immediately following the meeting entitled "Conclusions following meeting with Appointed Actuary". The note referred to the possibility of closing Equitable Life to new business.

4.59.27 The note concluded that GAD believed that Equitable Life was covering its minimum capital requirement at present, but had very little room for manoeuvre in the event of a modest fall in equity values. The note stated:

"The management seem to accept therefore that they have no alternative other than to arrange a sale and demutualisation if they are to remain open to new business. With the recent cut in bonus rates (and assuming that this is not reversed), new policyholders should not have to meet any of the cost of GARs, as indeed is likely to be their expectation. However, they will be joining a very weak fund.

"If the sale does not take place, then we shall almost certainly have to lean on them to stop writing new business, and they will very probably also need to rearrange their investment portfolio to a more defensive position. Otherwise, a full liquidation could be envisaged in the event of a substantial fall in equity values."

4.59.28 On 16 November 2000 the Appointed Actuary wrote to GAD following the meeting on 3 November 2000. The letter confirmed that Equitable Life's 1999 regulatory returns assumed only 85% take-up of the GARs. The Appointed Actuary stated that the GAO reserve was attributable between paid-up benefits and future premiums in the ratio of $\frac{1}{3} : \frac{2}{3}$. The Appointed Actuary enclosed the three actuarial reports produced by Ernst & Young on Equitable Life.

4.59.29 In his letter, the Appointed Actuary referred to various queries which had been raised in the bid process about Equitable Life's approach to resilience reserving, in particular, the inclusion of a charge of _% on accumulating with-profits pensions business:

“As I mentioned when we met, the Society's recurrent single premium contract is somewhat unusual, being effectively a unitised contract which is neither true single premium (like bonds) nor having a unit-linked style nil allocation period, and has never fitted the valuation regulations, which have been essentially based on a net premium valuation of level premium contracts, particularly well. As such, over the years, a certain amount of interpretation has been needed to determine minimum reserving requirements, particularly in resilience test conditions.

In particular we have included an allowance for unrecouped acquisition costs consistent with the spirit of regulation 68, which necessarily takes the form of a reduction in benefits. It has been my understanding that that was something discussed with GAD when my predecessor, R H Ranson, introduced the practice in the early 1990s. From the files I have inherited I cannot find specific correspondence on the topic but note that meetings were held in September 1992 and November 1993 when detailed discussion of the approach to resilience testing was a major item on the agendas. From the 1996 Returns onwards, following the new regulations requiring greater disclosure of the approach to resilience testing, the approach has been described in Schedule 4 each year - see, for example, paragraph 7(8)(a)(ii) of the 1999 Returns. For clarity I should confirm that the approach is only taken on contracts where future premiums are payable. True single premium products such as bonds and income drawdown products are excluded.

Because the approach is non-standard some of the prospective purchasers would like to see some more explicit confirmation that GAD feels the approach is reasonable and, accordingly, would not put pressure on the Appointed Actuary of the new entity to change the approach.”

4.59.30 The Appointed Actuary then set out his detailed justification for the approach.

4.59.31 The three actuarial reports which had been prepared by Ernst & Young for Equitable Life and were enclosed with the Appointed Actuary's letter were as follows:

- (a) Components of an Actuarial Appraisal of Equitable Life as at 31 December 1999 dated 25 August 2000;
- (b) Financial Projections of Equitable Life dated October 2000; and
- (c) Stochastic Financial Projections of the with-profits business of Equitable Life dated 8 November 2000.

4.59.32 The reports had been prepared for Equitable Life as part of a package of information to be provided to bidders in the bid process. The report setting out financial projections stated that the projections had been based on Equitable Life's reserving practice at year end 1999:

“Naturally, in some respects, this will differ from a purchaser's reserving practice. A different approach might lead to higher reserves, or lower reserves.”

- 4.59.33 Ernst & Young then provided four examples, three of which led to increased reserves and one of which led to a reduction. Ernst & Young also commented that there were some possible effects which they had not quantified, namely:
- “- Equitable could adopt a more efficient allocation of assets in the resilience tests;
 - Equitable could calculate non profit reserves using a gross premium methodology; and
 - Reserves could be based on the maximum of the discounted guaranteed amount, and a percentage of policy value.”
- 4.59.34 The reports were reviewed by GAD. GAD was concerned by a number of items. The debate with Equitable Life relating to these items continued beyond the Review Period.
- 4.59.35 On 22 November 2000 the Appointed Actuary sent IFSD the estimated solvency position at end October 2000. Excess assets were shown as £1080million. The Appointed Actuary commented that the position was broadly similar to the previous month.
- 4.59.36 On 23 November 2000 GAD wrote to the Appointed Actuary in response to his letter of 16 November 2000. The letter also followed up certain points arising from the scrutiny of the 1999 regulatory returns. Amongst other matters, the letter questioned and sought explanations for the issues set out below:
- (a) The consistency of Equitable Life’s approach to its GAR reserve with the Government Actuary’s 1999 guidance.
 - (b) The method and the assumptions used by Equitable Life in assessing the GAR liability on future premiums. The Ernst & Young report stated that a change in assumptions from assuming a 20% decrement per annum in future premiums to assuming no decrements in future premiums would lead to an increase in the GAR reserve of £360million. GAD asked the Appointed Actuary to justify the assumption of a 20% per annum reduction in future premiums on GAO contracts.
 - (c) The effect on the resilience reserve of a number of modifications in its method of calculation.
 - (d) The appropriateness of the _% charge on accumulating with-profits business used by the Society. Ernst & Young had stated that the removal of the _% charge had the effect of increasing liabilities by £950million.
- 4.59.37 On 24 November 2000 GAD submitted its detailed scrutiny report on Equitable Life’s 1999 regulatory returns. The format of the report was different from that used in previous years. In interview we were told that, in the preceding year, GAD had become increasingly aware that the FSA was adopting a risk-based approach to its regulation of life insurance companies. Accordingly, GAD considered it would be helpful, at least for the case of Equitable Life, to express the concerns which GAD had in that way, so that it would “mesh” with the way IFSD was monitoring companies.
- 4.59.38 The following categories were included in the scrutiny report: (a) capital risk; (b) reserve risk; (c) asset risk; (d) strategy risk; and (e) control risk.

- 4.59.39 GAD assessed that the Society was exposed to a number of risks - principally reserve risks (there were questions about adequacy of the reserving approach used in a number of places in the report) and asset risk (it would be particularly vulnerable to a fall in the equity market). The scrutiny report stated that, as far as capital risk was concerned, at first sight the solvency position looked reasonable, but the available assets of £3,861million to cover RMM of £1114million included a future profits implicit item of £925million, disregarded the liability to repay a subordinated loan of £346million and benefited from a reduction of almost £1.1billion in the GAO reserve from the reinsurance agreement. Without these items, the available assets would be just £1511million, "a less satisfactory picture for this large fund."
- 4.59.40 The report also noted that the aggregate asset shares were close to the value of the fund, that is, there was no estate. The £1.5billion 'saved' from the cut in reversionary bonuses after the House of Lords' judgment had been re-allocated to finance future GAO support and the likely costs of the rectification scheme.
- 4.59.41 Under the heading "Reserve risk", GAD noted that there appeared to be a wide range of ages over which benefits could be taken on accumulating with-profits pensions contracts at the option of the policyholder, without any market value adjustment being applied to the guaranteed benefits, and with the full value of any GAR (provided this attaches to their policy) being available. It was unclear to GAD whether the reserves were adequate to provide fully for this flexibility, and GAD questioned this in its letter to the Appointed Actuary dated 23 November 2000.
- 4.59.42 GAD made the following additional points in relation to reserve risks:
- "In the resilience scenario, the Society effectively takes credit for an additional % p.a. on the investment return. This appears to be justified as a 'Zillmer' adjustment to enable the Society to recoup unrelieved acquisition expenses. We are questioning this also.
- Inter alia*, the Insurance Companies (Amendment) Regulations 2000 are likely to lead to increased reserves on accumulating with profits business. We are asking the Appointed Actuary in our letter to confirm the impact on this Society, which we understand from our recent meeting to be much lower than is being suggested in the market.
- The Society utilises a reinsurance treaty with Irish European which provides protection to the Society should more than 60% (formerly 25%) of the benefits in any calendar year on the contracts which incorporate guaranteed annuity options be taken in guaranteed form. This is not wholly satisfactory from a regulatory perspective as it relies on regulatory arbitrage to achieve the desired result, and would not be available in the event of insolvency. It removes over £1billion of liabilities from Equitable's balance sheet.
- When setting GAO reserves, the Appointed Actuary assumes that 85% of benefits are taken in GAO form. This is a weaker assumption than that specified in the guidance of DAA13, although currently any assumption over 60% would be negated by the offset gained from the reinsurance treaty above."
- 4.59.43 Under the heading "Asset risk", GAD noted:
- "The Society is exposed to falls in the equity market. A sensitivity matrix supplied by the Society to FSA on 09.10.2000 shows the Society would be unable to cover its RMM if the FTSE-100 Index fell to around 5750 (a fall of 15% from end-August levels), though they are not particularly sensitive to movements in fixed interest yields."

- 4.59.44 Under the heading “Strategy risk”, GAD noted:
- “Without capital support from a prospective purchaser, the Society will be unable to reinstate the 7 months bonus foregone this year on the accumulating with profits pensions business. There are PRE issues here for both GAR and non-GAR policyholders. Indeed, the related question of whether the Society should be continuing to sell non-GAR policies in the same fund as that where the GAR policies reside could be considered to be an environment risk.”
- 4.59.45 On 29 November 2000 the Appointed Actuary wrote to GAD in response to the letter of 23 November 2000. The Appointed Actuary stated that the _% per annum allowance was justified, as it could be allowed for in the ways set out below:
- (a) Premiums for Equitable Life with-profits pension policies have a standard explicit charge of 4.5%. Part of that charge has been rebated by Equitable Life in recent years, but there was no guarantee of that practice continuing.
 - (b) The future profits calculation supporting applications for a section 68 implicit items order have for a number of years shown future profits of at least £2billion. The actual implicit items used have been £1billion or less.
 - (c) If the FSA proposals to use price earning ratios instead of dividend yields as a measure of the return on equities were adopted in the future, the Appointed Actuary stated that it would have a similar effect as to allow for the unrecouped acquisition costs.
 - (d) The Appointed Actuary suggested that the allowance could be recouped by applying a more sophisticated approach to the hypothecation of assets in the resilience test scenario.
- 4.59.46 The Appointed Actuary sought to justify the assumption of a 20% annual decrement in future premiums on GAO contracts by stating that "the premium income on this portfolio declined by 25% p.a. over the years 1997-1999 and not all premiums on the relevant classes are entitled to GARs.”
- 4.59.47 On 29 November 2000 IFSD requested a meeting with Equitable Life to discuss the main issues raised in the FSA’s discussions with potential bidders. This meeting is referred to in more detail in the section below dealing with the bid process. However, other matters which related to Equitable Life’s reserving and solvency were to be discussed at the meeting.
- 4.59.48 On 30 November 2000 IFSD circulated an e-mail internally and to GAD (though not to IB-PIA) suggesting an agenda for the meeting, including the following matters:
- (a) Equitable Life’s views on the bidding process;
 - (b) what contingency plans Equitable Life was making;
 - (c) Equitable Life’s response to GAD letter on reserving;
 - (d) PIA issues; and
 - (e) Equitable Life’s GAO rectification scheme.
- 4.59.49 The meeting took place between FSA and Equitable Life on 1 December 2000. IB-PIA was not invited to the meeting. The Appointed Actuary “agreed that the use of the 20% rate of decrement in assessing future premiums that secure GAR benefits

had to be reviewed. This rate reflected experience prior to the [House of Lords'] judgment, not after."

4.59.50 IFSD's conversations with two potential bidders on 1 December 2000, were recorded in an internal memorandum, indicating that it was possible that all bidders were about to pull out of the bidding and IFSD noted accordingly:

"Thus we may face a position, as early as Friday, where it is clear that no bid will be made by either party. We (and the Equitable Life) will need to be ready to respond quickly to that. My preference in that situation would be a very early announcement by the Company that they are closing to new business. In this case we would need to be ready to explain:

(a) the regulatory implications

(b) why we had not closed the company immediately after the House of Lords' judgment (or possibly even before that)."

4.59.51 On 4 December 2000 GAD wrote to the Appointed Actuary following up some points raised at the meeting on 1 December 2000. GAD confirmed the views expressed at the meeting.

(a) On the issue of reserving, GAD commented:

"We accept that, by assuming a GAR take-up rate of 85%, you have satisfied the requirements of the third paragraph of [the December 1999 reserving guidance], insofar as the reserves held on accumulating with profits pensions business have not thereby been reduced by more than 5%.

However, it is not intended that DAA13 should result in all offices assuming the same GAR take-up rate. In particular, the third paragraph of DAA13 says that 'it would not generally be prudent to assume that policyholders will chose a benefit form that is of significantly lower nominal value to them than the guaranteed annuity' ... whilst we accept that a reduction of 5% in the proportion electing to take the GAR on account of cash commutation is justified, any further reduction on account of perceived flexibility (which we take to be the reasoning behind the further reduction in the assumed take-up rate to 85%) needs to be viewed against the thinking above.

In our opinion, to achieve consistency with DAA13, in the context of GARs worth 30% more than current annuity rates, it would not be prudent to assume that more than 10% of policyholders would take cash or alternative benefits. This leads to a minimum assumed take-up rate of 90%.

We also note that Section 8 of DAA11 says that past experience alone should not be used when setting the proportions assumed to exercise the GAR in the future. Hence the recent experience of just 44% taking up the option does not of itself justify the use of 85% as a prudent assumption going forwards.

We recognise that whilst the current reinsurance arrangement remains in place, there would be no effect at the net level of strengthening the reserving assumption."

(b) On the rate of decrement on recurrent single premium business GAD noted that Ernst & Young had used a 10% annual decrement as a "realistic" assumption, that policyholders could elect to increase their premiums in future years (subject

to Inland Revenue constraints) and that GAD “would therefore be looking for a somewhat stronger assumption in this respect at the coming year end.”

- (c) The use of the $_%$ charge caused GAD particular concern and it told Equitable Life that “we do not believe that this valuation assumption would be acceptable in an insurer’s return as at 31 December 2000.”

4.59.52 The events leading up to the decision by Equitable Life to close to new business are set out below.

4.60 The bid process

- 4.60.1 We were told that when Equitable Life announced that it was putting itself up for sale the FSA considered, on the basis of information given to it by Equitable Life, that the Society was very saleable. There is no documentary evidence that the FSA analysed the consequences, at this stage, of the Equitable Life failing to find a buyer or requested any information from Equitable Life on this “worst case” scenario.
- 4.60.2 At the FSA’s request, on 11 August 2000 Equitable Life attended a meeting at the FSA with IFSD, GAD and GCD to discuss the bid process. Equitable Life had engaged a firm of investment bankers (Schroder Salomon Smith Barney (“**Schroders**”)) and appointed legal advisers and Ernst & Young to assist them in the bid process. Equitable Life informed the FSA that the Society intended to provide sales information to interested parties by the end of August 2000. Under cover of a letter from the Appointed Actuary dated 1 September 2000, IFSD received a copy of a draft letter from Schroders to potential bidders dated 25 August 2000 which referred to the Information Memorandum and to an actuarial report which had been prepared by Ernst & Young. The Schroders letter also appears on the GAD files. It was not, however, until a meeting on 3 November 2000, that IFSD requested a copy of the Ernst & Young actuarial reports from Equitable Life. The purpose of the meeting on 11 August 2000, the minutes of which are in a note dated 17 August 2000, was to discuss the regulatory aspects of the bid process.
- 4.60.3 The FSA outlined the regulatory processes which would be required for the sale to proceed and the likely timescales. The sale was likely to require a Schedule 2C scheme³⁰. The present timetable was for the sale to be completed by June 2001. It was pointed out that this was “extremely tight” and given that the purchaser would not be identified until the end of the year it was “very optimistic.”
- 4.60.4 On 1 September 2000 Equitable Life wrote to IFSD informing them that the Information Memorandum had just been issued and that the Managing Director would be telephoning IFSD with an update on the position. There was then no documented contact with Equitable Life regarding the bid process until a meeting on 3 November 2000 when IFSD requested a greater involvement in the bidding process.
- 4.60.5 In mid to late October and early November, IFSD met or spoke on the telephone to three potential bidders discussing mainly regulatory issues which might arise out of an acquisition. IFSD have noted in interview that comments made by the bidders to the FSA may have had the ulterior motive of “talking down the price.”
- 4.60.6 The FSA Board met on 19 October 2000. Michael Foot’s report to the Board contained an update on the preparation of revised guidance following the House of

³⁰ This is a statutory scheme under the ICA 1982 for the transfer of long-term insurance business from one body to another. Such a scheme has to be approved by the Court, because it affects, or may affect, the interests of policyholders.

Lords' judgment and an update on the bid process. The report noted that Equitable Life had had three serious offers and the Appointed Actuary of the Society had indicated to the FSA that the bids currently on the table were high enough to enable with-profits policyholders to gain restitution for the investment growth the Society had lost for the period 1 January 2000 to 31 July 2000 with additional goodwill on top.

4.60.7 By 25 October 2000 IFSD was aware that Equitable Life had asked for final bids by about 20 November 2000.

4.60.8 According to a note which was sent to Howard Davies and copied to Michael Foot, on 31 October 2000 IFSD was informed by one potential bidder that it was interested but it was becoming increasingly concerned about the financial implications of the deal:

“The more work they do in the data room the more they become convinced that the scale of the shortfall in the Equitable’s funds is greater than the Equitable Life themselves estimate. Moreover they are concerned that the wording of the Equitable’s policies would allow policyholders with guaranteed annuity options to increase the scale of their contributions (and hence the scale of the GAO liability) to the detriment of other policyholders in the fund.”

4.60.9 The potential bidder stated that it was “investigating whether this liability can be capped and if so how but again are more pessimistic than the Equitable directors of this issue.”

4.60.10 Howard Davies commented, by way of a manuscript note on the memorandum reporting this information: “Thanks. A useful communication. It does not lower my worry level about the Equitable. I think an early discussion with them is very much indicated.”

4.60.11 At a meeting with another bidder on 6 November 2000 mention was made of Ernst & Young’s actuarial appraisal of Equitable Life which had not, at that time, been seen by IFSD. Questions were raised by the bidder about Equitable Life’s reserving basis. Concern was expressed that Equitable Life’s current implicit items might be invalidated in any Schedule 2C scheme subsequent to the purchase. The bidder asked about the regulator’s attitude to financial reinsurance and, according to the note of the meeting, was told that the regulator did not support such arrangements which take advantage of regulatory arbitrage. The bidder pointed out that Equitable Life’s GAO reinsurance agreement fell into this category³¹. The bidder also asked the FSA to explain why in its resilience reserve Equitable Life was able to include a Zillmer adjustment which effectively added _% to the investment return.

4.60.12 Shortly after the meeting on 6 November 2000, that same bidder expressed its concerns about Equitable Life’s financial position to Howard Davies:

“They had reached the view that the Equitable’s financial position was considerably worse than they had first thought. The hole was significantly larger than they had expected ... And he said his main motive in telling me this was to alert me to the fact that the Equitable’s position might be rather more doubtful than we had been led to believe.”

4.60.13 On 14 November 2000 an internal memorandum was circulated at the FSA setting out how the possible outcomes of the bidding process might be handled. The note

³¹ Chapter 3 refers to GAD’s view of “regulatory arbitrage” in more detail.

considered various possible outcomes to the bid process including the possibility of no bid at all. In that event, it was proposed that:

“we would need to consider carefully whether we would wish to exercise any powers of intervention (if indeed the powers for us to do so exist in particular circumstances) ... We would in particular need to carry out a fairly robust analysis of the company’s financial position, for example to check the basis on which the accounts and financial statements have been prepared, so as to ensure that assumptions and projections remain valid for a radically different business model.”

4.60.14 The note continued:

“It is evident from the comments that have been made to the FSA by potential bidders that they have serious concerns about their potential exposure to the seemingly unlimited exposure of Equitable to certain liabilities, including the apparent rights of GAO policyholders to top up their cover. Equitable have indicated that the exposure is not as significant as some may have us believe and that in fact the liabilities are subject to a *de facto* cap, for example, by virtue of pensions/tax legislation.”

4.60.15 The concerns then being expressed about the financial condition of Equitable Life had led to some suggestions being made by the bidders as to possible forms of protection if the shareholders of any acquiring company were not to face an unacceptable degree of risk. The note examined the regulatory implications of this.

4.60.16 In mid-November 2000 there were further discussions between IFSD and the bidders. One of the bidders said that due diligence “had left [it] feeling that it wouldn’t be worth taking the Equitable at any price.” One of this bidder’s concerns was that there would be disgruntled policyholders at the end of the day because they would not be compensated for the loss of bonuses for the first seven months of 2000.

4.60.17 On 16 November 2000 GAD sent an e-mail to the FSA and GCD commenting on the memorandum of 14 November 2000. GAD’s view was that if no bidder was found Equitable Life would be in a very difficult position because it had stated publicly that it needed to find a partner with capital. Further:

“from a regulatory perspective, we know that their financial position remains very close to the edge of not covering their margin of solvency, there are a number of uncertainties (e.g. in the viability of their financial reinsurance and resilience to changes in financial markets - they are unable at present to satisfy one of the recommended resilience tests which they argue is quite strong and they point to a known anomaly in Regulation 69) and we would then also know that it would be difficult to arrange a rescue by another insurer in the event of technical insolvency arising.”

4.60.18 The e-mail concluded that the FSA would have to require Equitable Life to commission an independent investigation of its viability to write further business if it intended not to close to new business.

4.60.19 On 16 November 2000 Michael Foot prepared a report to update the FSA Board on recent developments within financial supervision. The report contained an update on issuing guidance on the implications of the House of Lords’ judgment and reported that a seminar had recently taken place with leading legal and actuarial experts. On the issue of the sale, his report stated that there were three potential bidders. It also stated:

“The due diligence process has revealed some concerns about how far liability for guarantees can be capped, since the guarantees appear also to apply to some future premiums. We are exploring with the Equitable the implications of this, both for the sale process and for the expectations of future policyholders if they continue to sell new business.”

- 4.60.20 On the same day an internal FSA memorandum, sent to Howard Davies and Michael Foot, among others, recorded that two of the bidders had “some reservations about continuing liabilities.” A main concern of one of the bidders was the open ended nature of the GAR liabilities. Howard Davies commented: “The bid [from one bidder] looks more promising, though I confess I don’t understand how they make the sums add up. The proposition [from another bidder] looks fraught with difficulty for us.”
- 4.60.21 On 17 November 2000 IFSD referred a point raised by one of the bidders to IB-PIA. This matter is described in **Chapter 5**. The bidder was intending, after acquisition, to close the with-profits fund to new business. IFSD considered that policyholders would be able to continue to “top-up” their existing policies. For those with GAR policies this was likely to be an attractive option and other policyholders in the Equitable Life with-profits fund would have to meet the additional GAR costs. The bidder had asked if this would be regarded as mis-selling to those policyholders who do not have GARs. IFSD received the response that the key issue was:
- “whether the reasonable expectations for the new sales to existing policyholders is greater or less than asset share given that the firm knows about a possible strain on the funds. If it is less then the firm has serious problems, since, I would suggest, the minimum PRE is asset share. If it cannot “promise” asset share then the warning that you could get back less must be disclosed and I suspect would make [it] unsellable.”
- 4.60.22 In late November 2000 various technical points raised by the bidders were considered by IFSD. IFSD considered whether eligibility to a future profits implicit item could be transferred and how the EC Directives impinged on this. Views tended towards a conclusion that a future profits implicit item could be granted to an acquiring company and these views, without confirmation that such an order would necessarily be granted, were confirmed to Equitable Life by letter dated 27 November 2000.
- 4.60.23 Further meetings took place with one of the bidders to discuss the structure of the proposed purchase, reserving issues and potential compliance issues. A further issue was raised relating to PIA Rule waivers. PIA responded to this query in early December 2000.
- 4.60.24 On 23 November 2000 in an internal memorandum to Michael Foot it was reported that one of the bidders was putting together a bid which was likely to be attractive to the Equitable Life Board. There were two points, relating to the structure of the Equitable Life funds after the acquisition and the preservation of the value of the business between the bid being recommended to Equitable Life’s members and their vote on it, on which that bidder required comfort from IFSD. In respect of the first, IFSD had suggested a variation on the proposal which appeared acceptable in regulatory terms. The second raised issues relating to PIA Rules and an urgent meeting was to be set up with the relevant people in IB-PIA. This matter is described in **Chapter 5**.
- 4.60.25 In late November 2000 GAD provided advice to IFSD on the structure which was being proposed by one of the bidders and the implications of that structure for PRE and reserving.

- 4.60.26 On 23 November 2000 IFSD received a call from Equitable Life who wished to keep IFSD in touch with Equitable Life's views on progress towards a sale. Two bidders were discussed and the note records:
- “We did not talk about the possible price that either ... bidder might offer but, from what he said, I had the impression that [Equitable Life's Managing Director has] much more realistic expectations now than he did a few weeks ago.”
- 4.60.27 In late November 2000 there were further meetings with one of the bidders.
- 4.60.28 On 1 December 2000 an internal e-mail was circulated within IFSD. The concern was expressed that if a sale was to proceed, Equitable Life would need to obtain separate votes from GAR and non-GAR policyholders. It was suggested that IFSD request scenario testing of the adequacy of a GAR sub-fund in different economic scenarios.
- 4.60.29 A meeting with Equitable Life was held on 1 December 2000. The meeting had been arranged to obtain an update on the bid process and to discuss reserving issues. According to the note of the meeting prepared on 4 December 2000, Equitable Life confirmed that there remained only two bids, one of which involved a very small offer price with no goodwill element for policyholders and, as regards the second, Equitable Life had real concerns that the bidder was not offering sufficient cash “to allow the Society to proceed with this option in any case” in which case Equitable Life would close to new business and sell the infrastructure and sales force.
- 4.60.30 IFSD decided to prepare a paper looking at possible outcomes of the bid process - closed fund and acquisition by each of the two remaining bidders (each of which proposed different structures) against the relevant FSA objectives of protection of consumers and market confidence. The paper was also intended to consider the compensation scheme and interim arrangements including a “pre-emptive” sale of the sales force which was contemplated by one of the bidders.
- 4.60.31 On 4 December 2000 one of the bidders pulled out. The other (last) bidder told the FSA that it was “increasingly concerned” that acquisition of Equitable Life would not be economic and the aim was that the bid would be considered by its Board on 7 December 2000 and that there was no way of predicting the recommendation which would be made. That bidder decided not to proceed with an acquisition on 7 December 2000.

4.61 Equitable Life's GAO Rectification Scheme

- 4.61.1 On 11 August 2000, at a meeting between Equitable Life, IFSD and GAD, Equitable Life told the FSA that:
- “compensation would be due for policyholders. The latest estimate of this cost was £150m - the Appointed Actuary said that the worst case scenario for compensation was £350m. Compensation would be a difficult exercise evaluating the consequence of the directors re-exercising their discretion. For those that had remained with the Society this would be more straight forward process. But for those who had left the Society and for example, taken an open market option, compensation would be much more difficult to assess. As previously proposed an independent claims assessor would be responsible for assessing entitlement to compensation for cases where it could be argued that a

policyholder would have chosen an Equitable GAR policy rather than another option if he had been given the improved offer at vesting.”

- 4.61.2 Equitable Life asked whether the FSA would be able to give a view on the Society’s compensation proposals so that they could be said to be “approved by the FSA.” IFSD was non-committal on this point but thought it sensible to have a look at what the Society intended to do.
- 4.61.3 On 9 October 2000 the Appointed Actuary sent IFSD a copy of the letter sent to policyholders regarding the compensation scheme and noted that Equitable Life was at an advanced stage in obtaining the endorsement of the independent experts.
- 4.61.4 At a meeting on 3 November 2000 Equitable Life reported that it was close to finalising the compensation scheme:
- “allowing relevant GAR policyholders from 1 Jan 1994 to this year the ability to re-choose a scheme based on a higher level of GAO. The scope of the review will cover 26,000 cases and some 20,000 AVC schemes. For some of the earlier years - when interests rates were higher - the additional GAR benefits are marginal, (and for part of 1994-95 the GAR rate is non beneficial) greater benefits are concentrated in the later years when interest rates were low. The Appointed Actuary thought that general inertia and concern over changing pension arrangements would mean that policyholders would not change their arrangements unless there was a reasonable additional benefit of say at least 10%.”
- 4.61.5 Equitable Life also reported that the aggregate value of the compensation scheme was £200million and that Lord Browne-Wilkinson was involved in the construction of the scheme and an independent actuary was reviewing its terms.
- 4.61.6 At a meeting on 3 December 2000 attended by Equitable Life, IFSD and GAD, the Managing Director of Equitable Life confirmed that the compensation scheme had recently been “signed off” would be put before its Board on 7 December 2000 and affected policyholders would be contacted shortly afterwards. We understand that Equitable Life’s rectification scheme has not yet been finalised.

4.62 Decision to close to new business

- 4.62.1 On 1 December 2000 a meeting took place between Equitable Life, IFSD and GAD. According to the minutes of the meeting, Equitable Life:
- “did not appear to be unduly concerned about WP policyholders who joined the Society after the House of Lords’ judgment. Although it was conceded that the Board had to make a decision on whether to carry on writing this business within a couple of weeks depending on the outcome of the sale process. The Society had not considered whether post 20 July WP policyholders could be excessively disadvantaged in a closed fund. This is because after this date the preferential treatment of GAR policyholders was known. Going forward if GAR policyholders had a greater propensity to top up their benefits than previously this will be to the detriment of non GAR policyholders.”
- 4.62.2 Equitable Life confirmed that the sales force were adequately briefed and instructed to advise potential with-profits policyholders on the Society’s particular circumstances prior to sale. Equitable Life also reported that its Board had taken legal advice on whether it should continue to write new business.

- 4.62.3 IB-PIA was not invited to, and did not attend, this meeting. IB-PIA was not sent a copy of the minutes.
- 4.62.4 On 3 December 2000 GAD prepared a note on the options available if no sale of Equitable Life was achieved. The note had three sections - closure to new business, means to improve statutory financial position and means to improve realistic financial position. The note stated that Equitable Life was “almost certainly too vulnerable to continue writing business” if the sale fell through and, in that event, it would “need to close or commission an independent report to show that they were indeed viable to continue as an open fund.”
- 4.62.5 On 5 December 2000 IFSD held an internal meeting to deal with matters which might arise on closure. This included arranging a meeting of the Tripartite Standing Committee³² and contacting overseas regulators, the press office, the ABI and discussing with GAD the solvency position and possible use of formal powers.
- 4.62.6 On 5 December 2000 IFSD sent a memorandum to Michael Foot in advance of a meeting with Equitable Life. Equitable Life’s end of October 2000 solvency figures showed free assets of £1080million. IFSD noted that the latest estimate was that:
- “Equitable has free assets of £70m above the required minimum margin of solvency. (This margin has built into it the “resilience test”, which allows for a 25% fall in equities; but even so this margin is uncomfortably tight). This estimate is £1010million less than the Equitable’s own estimate; the reason for the difference is that GAD have made adjustments to a variety of assumptions in the reserving basis, to bring them into line with what they would normally expect.”
- 4.62.7 The note stated that in the absence of a bid:
- “it is very difficult to see how the Equitable Life could justify continuing as a going concern ... We believe we would have grounds for closing the company to new business under the Insurance Companies Act (either for failing to meet its required minimum margin of solvency, or because of the risk that PRE would not be met). But we would prefer that the Equitable Life’s directors took this decision for themselves.”
- 4.62.8 On 5 and 6 December 2000 there was an exchange of e-mails between Michael Foot and IFSD in advance of the meeting with Equitable Life on 6 December 2000.
- 4.62.9 In his e-mail, Michael Foot highlighted three areas which he considered were likely to arise:
- (a) the powers which the FSA has if there are no bidders for Equitable Life and it was not willing to voluntarily suspend business;
 - (b) what policyholders should be told about the implications of a cessation to new business; and
 - (c) what should be said in answer to questions about other firms’ exposure.

³² The Tripartite Standing Committee is a committee of representatives of HM Treasury, the Bank of England and the FSA which meets on a monthly basis to discuss cases of significance and other developments relevant to financial stability. Meetings can also be called at other times by one of the participating institutions if it considers there to be an issue which needs to be addressed urgently. In exceptional circumstances, the Bank may implement an operation beyond its routine activity in the money market to implement its interest rate objectives. Such a support operation is expected to happen very rarely and would normally only be undertaken in the case of a genuine threat to the stability of the financial system to avoid a serious disturbance in the UK economy. If the Bank or the FSA identified a problem where such a support operation might be necessary, they would immediately inform and consult with each other.

- 4.62.10 IFSD responded to these points later that evening. IFSD commented that its view was that because GAD had clarified how thin and fragile the company's margin was, the FSA could be reasonably robust. This would entail telling the company that the FSA could not allow Equitable Life to continue to write new business. IFSD understood that this was consistent with the advice which Equitable Life's directors had already received. There might be some debate about whether Equitable Life should have a period of grace to enable there to be a "fire sale." So far as the implications of cessation were concerned, IFSD noted that it agreed:
- "that the company and the ABI should so far as possible take the heat... We need to be careful over top-ups. Initial (but firm) legal advice is that our intervention powers do not allow us to interfere in contracts (and the right to top-up is a contractual one). I suspect that our emphasis should be on ensuring that there is proper transparency and information so that those who wish to top-up do so advisedly and in full knowledge of the situation. This will be particularly so where the E is an AVC provider and we will need to consider getting the E to write to the relevant trustees urgently to draw their attention to the issue and to suggest that they consider carefully whether they (the trustees) wish to continue assisting members to put their funds with them. We should perhaps also consider talking to OPRA³³ tomorrow."
- 4.62.11 GCD advice on 6 December 2000 specified the statutory powers under which intervention action could be taken:
- (a) section 12A of the ICA 1982 (suspension of authorisation in urgent cases) where it appears that any of the criteria of sound and prudent management is not or has not been fulfilled, or may not be or may not have been fulfilled, or that an obligation under the ICA 1982 has not been satisfied; and
 - (b) section 45(1) of the ICA 1982.
- 4.62.12 On 6 December 2000 Equitable Life met IFSD and GAD to discuss the prospects for the Society. Michael Foot chaired the meeting. IB-PIA were not invited to, and did not attend, this meeting.
- 4.62.13 The note of the meeting records that Equitable Life was aware that the one remaining bidder was unlikely to make a bid. Equitable Life had during the past five to six weeks considered the options if no bid emerged and had decided that "in these circumstances the with-profits fund would have to close and very likely the unit linked business." IFSD pointed out that the FSA would have a problem allowing Equitable Life to write unit-linked business because it appeared that these contracts contained provisions whereby the value of the policies could be reduced to pay for the wider liabilities of Equitable Life. The Society accepted this point and agreed that if the last interested bidder did not make a bid, Equitable Life would close to all new business.
- 4.62.14 It was agreed that press handling of the situation should be co-ordinated and that certain overseas regulators where Equitable Life carried on business would need to be briefed.
- 4.62.15 On the financial side, the Appointed Actuary stated that the investment strategy would need to move to a more conservative position.

³³ OPRA, the Occupational Pensions Regulatory Authority, was established by Parliament under the Pensions Act 1995 to help ensure that occupational pension schemes are safe and well run .

- 4.62.16 It was confirmed that the status of the subordinated loan was safe if the Society closed to new business. Similarly, the reinsurance agreement still held good if the company stopped writing new business. Surrenders would have to be monitored closely “so as to deter excess surrenders which could further jeopardise the Society.”
- 4.62.17 Equitable Life mentioned the possibility that there might be claims for mis-selling based on the much lower estimated cost of the GAR liability represented to potential policyholders prior to the House of Lords’ judgment.
- 4.62.18 On the same day the last potential bidder informally indicated its withdrawal from the bidding process.
- 4.62.19 On 7 December 2000 an internal meeting was held at the FSA attended by IFSD and GCD to discuss potential timing and press releases in advance of any announcement that the last bidder had withdrawn.
- 4.62.20 On 8 December 2000, by way of a co-ordinated announcement by the FSA and Equitable Life at 7:30 am on the London Stock Exchange Reuters News System, the Society declared that it was closed to new business.