Chapter Six

Overall Assessment

6.1 Preamble

6.1.1 Life insurance is, by its nature, a long-term business and, on the whole, problems tend to emerge slowly. Similarly, corrective action can often take time to deliver a solution. But, unlike banks, life insurance companies cannot re-price their products to reflect market changes.

6.1.2 To a large extent, the prudential regulatory requirements reflect these features of the life insurance industry and the need to maintain a strong solvency position that covers not only current conditions but can cushion adverse changes in the future. This is achieved by prudent valuation of the assets and liabilities, and the need to ensure that solvency can still be demonstrated in the event of a fall in equities and/or changes in interest rates. On top of this, most with-profits life companies hold substantial free assets which allow the company, despite the guarantees it offers, to invest in equities in the expectation that they will generate a higher return for their policyholders over time.

6.1.3 The weakness of a company with a low level of free assets can ostensibly be repaired by subordinated loans and accelerating the recognition of future profits by the use of implicit items and financial reinsurance agreements. These latter features may be viewed as mortgaging the future to strengthen the present and, when in place concurrently with little or no free assets, render the company poorly placed to withstand a major financial shock.

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

6.1.5 Against the above background, the prudential regulator has to exercise judgements so that it is confident that the company will remain solvent and meet the reasonable expectations of policyholders, without intruding unreasonably into the management of the company.

6.1.6 Concurrently with, but in such circumstances subsidiary to, prudential regulation, conduct of business regulation will seek to ensure compliance with its rules, which are in the main aimed at ensuring that policyholders are properly advised about a company's investment products, and are not misled.

6.2 Introduction

6.2.1 In this Chapter we give an overall assessment of the discharge by the FSA of its functions under the ICA 1982 and by the FSA of its functions on behalf of the PIA under the FSAct 1986 during the Review Period. For this assessment of the FSA's performance to be understood in its proper context, certain important considerations about the nature of the problem and the environment in which the regulator was then operating should be borne in mind.

6.2.2 When responsibility for the prudential regulation of Equitable Life was transferred to the FSA, the treatment by Equitable Life of its GAOs was already a high profile, "live" issue and was the subject of discussions which had been initiated by HMT-ID. In late December 1998, Equitable Life had decided, on its own initiative, to commence proceedings in the High Court to test the lawfulness of the terminal bonus practice which it had adopted in respect of the GAOs.

6.2.3 The guarantees had been included in policies which had been written many years before the FSA assumed responsibility for the prudential regulation of the insurance industry. It is important to recognise that, once the GAR took effect (which, being leveraged, it did rapidly), there were no quick solutions or cures for a company in the position of Equitable Life, a mutual with-profits insurer which had limited free assets. In the event of such a contingent liability crystallising (which was the effect of the House of Lords' judgment), the only viable option open to it was to raise external additional capital by putting itself up for sale.

6.2.4 Accordingly, applying hindsight, it is fair to say that, by 1 January 1999, the "die was cast" and we have seen nothing which the FSA could have done thereafter which would have mitigated, in any material way, the impact of the outcome of the Court case as far as existing policyholders were concerned, or made any material beneficial difference to the final outcome so far as Equitable Life was concerned.

6.2.5 That said, our assessment does identify a number of things which the FSA could have done better. There were occasions when both the prudential and the conduct of business regulators did not spot issues to be addressed or, having spotted them, did not follow them up. The significant instances of these we set out below. One of the reasons why issues were missed was the poor level of communication and co-ordination between the two arms of regulation, prudential and conduct of business. We look at this in more detail at the end of this Chapter.

6.3 The Regulatory Environment

6.3.1 As is set out in the FSA publication "New Regulator for the New Millennium", the FSA is developing a new risk-based regulatory approach to deliver its statutory objectives effectively and efficiently. This new way of working is being introduced progressively in preparation for N2.

6.3.2 Therefore during the Review Period the process of integrating the various regulators and creating a new regulatory culture was in its infancy. Until FSMA 2000 comes in to force at "N2" and with the old regulatory structure, including the continued existence of the SROs, still in place, the *de facto* integration of the regulatory structure remains subject to constraints. The new approach is intended to provide greater focus of the FSA's monitoring of and influencing those institutions and activities which are likely to pose the greatest risk to consumers and markets, and the FSA will take account of the proper responsibilities of consumers themselves and of firms' management. The Review Team recognises that it takes time for both structural and cultural changes, which the FSA has determined to adopt, to be implemented and to take effect.

6.3.3 We also acknowledge that the FSA has finite resources and, as a consequence, is continually exercising its judgement of risks to determine how to deploy its resources to best effect, having regard to "proportionality", "economy" and "efficiency". During the Review Period, in addition to "business as usual", its senior management was also heavily engaged in preparing for the new regulatory regime and other projects. Representations have been made to us, particularly in the context of IB-PIA where the ratio of "client base" to resources is very much higher than in other divisions, that this was a distraction from the routine work of supervision.

6.3.4 Without undertaking a review of all other work for which the FSA was responsible it is not possible to comment except to say that (a) IFSD did not see lack of resources as an issue in the prudential regulation of Equitable Life, and (b) we do not consider that the points we make in this assessment necessarily require anything other than a moderate increase in resource, but rather a better application of resource. However, additional resources will be needed by the prudential regulator of insurance

companies if it is to meet the demands of the new post N2 regulatory regime. This matter is referred to in our recommendations of lessons to be learned.

6.4 The Review Team's Approach

6.4.1 The purpose of the FSA Board in commissioning this Review was to learn the lessons from this episode. This necessarily requires us to form conclusions about how the task of regulation was managed during the Review Period. Comments which are critical of the FSA, any person or entity, may have been informed by hindsight, which we have not sought to exclude, and are included only for the purpose of identifying how things can be done better in the future.

6.4.2 Any assessment of the FSA's and the PIA's discharge of their respective functions can only be done by reference to their respective duties and powers. These are set out in detail in **Chapter 2**. This Chapter assesses the performance of each of the regulators separately. In each section a short summary of the relevant regulator's duties and powers is set out and its performance is then assessed. The Chapter concludes with some general comments about the co-ordination and communication between the two regulators.

Prudential Regulation

6.5 The FSA's duties and powers

6.5.1 The FSA's general responsibilities are set out in the Schedule to the Treasury SLA:

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

6.5.2 The Schedule further states that the supervisory resource will be focused on the following:

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

> "While these objectives [of FSMA 2000] are not yet enacted ………… they serve to inform the general approach the FSA proposes to take during the period prior to the new legislation coming into force."

6.6 Assessment - Prudential Regulation

6.6.1 At the outset IFSD, advised by GAD, (**"the prudential regulator"**) addressed the issue of reserving for the guarantees in a resolute manner. There were, however, some particular issues which the prudential regulator missed or failed to follow up, with which we deal below. Subsequently, the prudential regulator and the senior management at the FSA were surprised by the outcome of the Court case and then by the failure of Equitable Life to find a buyer.

6.6.2 Because the outcome of those events could not be predicted with any certainty, it was important to be prepared for all likely eventualities. In respect of this episode, we believe that if the prudential regulator had been more proactive and adopted a more challenging, carefully co-ordinated and researched approach, then it would have allowed itself more time and been better informed, to consider in conjunction with Equitable Life, how best to manage the consequences for the policyholders of the judgment of the House of Lords. It would also have been in a position to reflect more carefully on what information Equitable Life should have been giving to policyholders, both existing and potential, before and after the House of Lords' judgment.

6.6.3 Although we have already said the "die was cast", this does not absolve the prudential regulator from its duty to consider what possibilities there might have been to mitigate the effect of any "fall out" for policyholders. In different circumstances there may have been other opportunities or more difficult choices to be made.

6.6.4 Nor do we believe that the approach, which we have suggested should have been adopted, would necessarily have involved committing anything other than a modest increase in resources over those already deployed by the regulator at the time.

6.6.5 We now turn to more specific issues.

6.7 Reserving

6.7.1 Throughout the discussions with Equitable Life, HMT-ID and, after 1 January 1999, IFSD (both advised by GAD) maintained that the level of reserves which Equitable Life had established for GAOs was inappropriate and that Equitable Life needed to establish reserves at, or close to, 100% of the full value of the GAOs. In the regulator's view, prudence required that GAOs be fully reserved.

6.7.2 We believe that the position adopted by the prudential regulator was appropriate and that it was right to require that this level of reserves be established.

6.7.3 We consider that the prudential regulator addressed the issue of reserving for the guarantees in a resolute manner notwithstanding the stance adopted by Equitable Life in defence of its views on reserving. In the event, the regulator's view prevailed and Equitable Life agreed to establish higher reserves in its 1998 regulatory returns.

6.8 Reinsurance Agreement

6.8.1 Equitable Life was to a large extent assisted in establishing these higher reserves for the year end December 1998 by entering into a financing reinsurance agreement. The agreement was only effective as long as Equitable Life did not change its terminal bonus practice. If such a change occurred the reinsurance offset would collapse, reducing the level of solvency significantly. It is not for the regulator to decide whether or not to accept a reinsurance agreement entered into by a life company as a means of complying with its statutory reserving requirements. The Appointed Actuary's reserving decision is his own and is one which is required to be prudent and is governed by his statutory and professional duties. The regulator may intervene if it considers that the Appointed Actuary's decision in relation to reserving or reinsurance is a breach of the criteria of sound and prudent management. Reinsurance agreements are permissible under the reserving regulations. In the circumstances of this case, we do not consider that it would have been reasonable for the regulator to have intervened on the grounds that there was a breach of the criteria of sound and prudent management.

6.8.2 However, in its regulatory returns, Equitable Life did not disclose that the reinsurance cover effectively remained in place only for as long as Equitable Life did not change its terminal bonus practice. We consider that IFSD should have required the disclosure of this condition of the reinsurance agreement in the regulatory returns for the following reasons:

(a) One of the reasons for requiring Equitable Life to make early submission of the 1998 returns was to ensure that policyholders and potential policyholders were not misled as to the company's financial strength. Accordingly, we consider that a decision not to require disclosure of this condition of the treaty was inconsistent with the reasoning behind the requirement for early submission by Equitable Life of its 1998 regulatory returns.

(b) It was also inconsistent with the view taken by HMT-ID in December 1998 when, in a letter to Equitable Life in December 1998, it had expressed an expectation that an appropriate statement on contingent liabilities should appear in its 1998 returns related to the risk of a successful challenge to its terminal bonus practice. This statement itself never appeared in the regulatory returns and IFSD did not pursue this point with Equitable Life, despite the fact that in the meantime Equitable Life had commenced court proceedings to determine whether the practice was lawful.

6.8.3 The reinsurance agreement was not signed by IERC until 30 September 1999 and by Equitable Life until 11 October 1999. Credit had been taken for the reinsurance agreement in the 1998 regulatory returns, which were submitted to the FSA in March 1999. IFSD was confident that Equitable Life had a clear intention to enter into it and knew that heads of agreement had been discussed before the end of 1998. However, we are concerned that reliance should be placed by the regulator on an agreement which was material to Equitable Life's ability to comply with its statutory solvency requirement when that agreement had not been executed by both parties.

6.9 Resilience test

6.9.1 We were told that GAD reviews the regulatory returns, and will seek "to clarify points, which are unclear" but does not audit them. During the Review Period, in Schedule 4 paragraph 7(8)(a)(ii) of the regulatory returns for 1998 and 1999, it was stated that:

> "for all accumulating with-profits business, an annual loading of .25%o [*this figure varied year on year*] increasing by 4% per annum compound of the basic benefit was reserved which is considered to be a prudent allowance for ongoing expenses: for accumulating with-profits pensions business, _% pa of the benefit value has been deducted for each year up to the date it is assumed that benefits will be taken as a charge for expenses."

6.9.2 The second part of this disclosure (following the colon) is unclear in the context and therefore in our view should have been questioned. It described practices that did not conform to the expectations of GAD. Eventually GAD was alerted to the issue in late 2000 when it requested and was provided with copies of the Ernst & Young reports which were prepared to assist potential purchasers in the bid process. We understand that it was amended in the regulatory returns for 2000. The negative impact on solvency of removing the _% pa was estimated by Ernst & Young to be just under £1billion.

6.9.3 Had the prudential regulator enquired about the wording, it would have recognised sooner a significant weakness in Equitable Life's solvency position. Fortuitously, when it was identified, there was a significant compensating adjustment in respect of

a different hypothecation of assets in the sum of £800million within the resilience test.

6.10 Increments

6.10.1 During the Review Period, GAD was aware of the existence of entitlements in GAO policies to pay additional premiums (or "top-up" the policies), which themselves would attract the GAR. However, the prudential regulator did not question the reserving basis for these, despite information received from Equitable Life in response to the GAD survey in 1998 that such entitlements were available. The issue of exposure to top-ups was considered further at a meeting in November 1998, in a telephone conversation between GAD and the Appointed Actuary on 29 January 1999 and later in October and November 1999 in the context of a question from IB-PIA regarding the number of top-ups to GAO policies. Further, neither IFSD nor GAD appear to have appreciated the significance of the fact that the exposure could neither be reliably quantified nor capped.

6.10.2 Had IFSD or GAD identified this issue sooner, it might have heightened their awareness of the possibility that Equitable Life's liability to GAR policyholders might be significantly increased by top-ups after the House of Lords' judgment and they might have recognised a potentially significant obstacle to the sale of Equitable Life.

6.11 Operation of the Insurance Supervisory Committee

6.11.1 Shortly after the House of Lords hearing and before the judgment, Equitable Life requested a Section 68 Order permitting a proportion of future profits to be counted towards solvency in the regulatory returns for 2000. Prudential Guidance issued in 1984 states that such Section 68 concessions "will be readily available" and it is our understanding that it had been the practice to grant them, provided that the requirements in the regulations had been satisfied.

6.11.2 A paper was prepared by IFSD, after the House of Lords' judgment, incorporating advice from GAD, to the ISC inviting them to approve a recommendation to HMT to grant approval of this item. However, this was a short paper and only summarily dealt with the wider background. It did not consider the cumulative effect that this implicit item, the subordinated loan and the reinsurance agreement had on alleviating Equitable Life's weak regulatory capital base and the impact this in turn may have on its ability to meet the reasonable expectations of potential policyholders.

6.11.3 The paper did not mention that the summary figures for solvency provided by Equitable Life were based on an older, weaker resilience test than the one GAD considered appropriate for current conditions. Although the adoption of any particular resilience test is not compulsory, it is notable that, had the normal test been used, Equitable Life would have failed to meet its RMM without the implicit item requested. Also the paper did not mention that GAD's advice had been given before the House of Lords' judgment even though the decision was being taken after that judgment. Without meeting (although with an opportunity for members to comment) the ISC approved the Order.

6.11.4 In the circumstances, we do not disagree with the approval of the Order. For the ISC to have refused the application would have been exceptional and inconsistent with allowing Equitable Life to continue to write new business while seeking a buyer. However, we consider that the process leading up to the decision was flawed, because important issues were not highlighted or explained to the ISC.

6.12 The Court case

6.12.1 Equitable Life had already decided to embark on the Court action when the FSA assumed responsibility for its prudential regulation. The decision to bring the proceedings in late December 1998 was taken, so HMT-ID was told, on the advice of Leading Counsel, in order to "confirm that the Society's directors had acted entirely properly and within powers in adopting the terminal bonus practice."

6.12.2 We have considered whether the FSA should have sought to become involved or intervened in an appropriate way in the Court case given the potential implications for the industry. We were told that this possibility was considered, albeit briefly, by IFSD, GAD and GCD following a meeting with Equitable Life, but it was not pursued. In interview we were told that it was perceived that there would be real resistance from the Court in allowing a public body to intervene in what was essentially a contractual dispute between private parties. The Order which was made by the Court on 23 February 1999 provided that Mr Hyman was to represent the interests of all policyholders or former policyholders of Equitable Life who had an interest in a policy containing a provision for GARs. The Court also ordered that Equitable Life was to represent the interests of all other with-profits policyholders and so all the relevant interests were represented before the Court.

6.12.3 It was suggested that one possible role which the FSA could have played in the Court case was to set out its views on PRE, in particular the balance which needed to be struck, within a mutual fund, between the expectations of the GAR and the non-GAR policyholders. However, in its application to the Court, Equitable Life had sought confirmation that it was entitled to adopt its differential terminal bonus practice either as a result of the discretion afforded to the directors in the Articles of Association or as a matter of contract. PRE was not one of the issues which was directly raised by Equitable Life's originating summons. Given the terms of the Court's Order of 23 February 1999, namely that Mr Hyman represent the interests of all GAR policyholders and Equitable Life represent the interests of all other with-profits policyholders and given the issues raised on the face of Equitable Life's originating summons, we find it difficult to identify either on what basis the FSA could have sought to become involved in the case or what value would have been added by its involvement.

6.13 The decision to defer consideration of PRE

6.13.1 In the latter part of 1998, HMT-ID had been provided with various examples of communications sent by Equitable Life to its policyholders to enable it to consider whether Equitable Life's terminal bonus practice was consistent with PRE. However, Equitable Life's decision to initiate the Court case caused the regulator to defer reaching a conclusion on its consideration of PRE until after the Court case. The view was taken that, in order to reach a decision on PRE, it would have been necessary, amongst other things, to reach a view on the terms of the contract and this was one of the questions which was before the Court. We agree that this was the right decision.

6.13.2 However on a number of occasions, most notably at the time of the hearing at First Instance, it was recognised by IFSD and others that, if the Court did not definitively resolve the matter from the PRE perspective, then the FSA would have to undertake a significant exercise to determine whether there was a risk that Equitable Life would be unable to meet PRE. If such a risk was identified then the regulator would have grounds to intervene. IFSD therefore recognised that in the circumstances it was desirable that work be undertaken ahead of the judgment to ensure they were in a position to reach a preliminary view within a reasonable time period thereafter. We have seen little evidence of any concerted effort to complete that preliminary review, although IFSD did initiate an exchange with IB-PIA seeking their views on their

powers in respect of bonus notices and as to whether the notices were misleading or not. PRE was viewed as a particularly nebulous concept and the absence of a framework within which to determine the issue undoubtedly added to the difficulties facing IFSD in assessing Equitable Life during this period.

6.13.3 We believe that a more concerted effort to carry out that preliminary work on PRE would have been beneficial for three reasons. Firstly, it would have informed the regulator so as to enable it better to judge the PRE implications of any decisions taken by the Equitable Life following the outcome of the Court case. Secondly, it would have assisted in identifying earlier and more conclusively the appropriate division of responsibilities as between the prudential and conduct of business regulators for monitoring and, if appropriate, reacting to information disseminated by Equitable Life to its policyholders during the currency of the policy. Thirdly, work undertaken on this topic would have been valuable input to the development of the new regulatory regime.

6.14 Financial Projections

6.14.1 When the FSA assumed responsibility for the prudential regulation of Equitable Life, a number of financial issues remained in play which had been the subject of discussions between HMT-ID and Equitable Life in late 1998. These issues included the low solvency cover of Equitable Life in general and, in particular, the appropriate level of reserves which Equitable Life should establish for GAOs.

6.14.2 IFSD wrote to Equitable Life in early 1999 requesting further information to help form a better understanding of the current financial condition and resilience to changing investment conditions. Over a period of time, some, but not all, of this information was supplied, including certain projections indicating that in a "low" investment scenario (albeit with benign equity performance) taken together with the loss of the Court case (although not in the worst case scenario that eventually transpired), the position would become "unacceptably tight".

6.14.3 Although the information indicated a potentially serious situation, it was not enough to give IFSD or GAD a full and sufficient understanding of:

(a) the potential impact of volatile investment conditions in the short and medium term on Equitable Life's weak financial position;

(b) the risk of Equitable Life failing to meet its RMM;

(c) Equitable Life's ability to declare bonuses under less benign investment conditions; and

(d) the risks faced by incoming policyholders.

6.14.4 In circumstances where Equitable Life had substantially exhausted its ability to recognise future profits implicit items, a better understanding of the matters set out at (a) to (d) above would have enabled the FSA more appropriately to assess the threat not only to Equitable Life's future solvency and but also to its ability to meet PRE. Such an understanding would have better informed any consideration by IFSD as to whether it needed to take any further action, whether informally or formally, to protect policyholders or potential policyholders. It would also have better informed the scenario planning done for the outcome of the Court case.

6.15 Planning for the Court judgments

6.15.1 Although we agree with the FSA's decision not to become involved in the Court case, we do think that IFSD was insufficiently prepared for the House of Lords'

judgment to be able to react appropriately to events and to any decisions of Equitable Life which might have flowed from the judgment. The lack of preparedness stemmed from a lack of scepticism about the outcome of the legal proceedings, based partly on a misconstruction of the legal briefings which had been received about the nature of the decisions of the judges in the Court of Appeal, and partly as a consequence of being influenced by Equitable Life's confidence in its case.

6.15.2 The scenario planning document produced by IFSD in consultation with GAD and GCD in July 1999 was perceptive. It recognised the possibility that the Court Order would mean that Equitable Life would have to reduce substantially the bonus paid to all with-profits policyholders if "ring-fencing" was not accepted by the Court. This was the effect of the House of Lords' judgment. It also predicted the possibility that a reduction in bonus might precipitate, amongst other possibilities, a take-over bid. It did not go so far as to envisage Equitable Life being forced to put itself up for sale. That was where the scenario planning process stopped.

6.15.3 GAD had suggested that these scenarios be considered alongside the financial projections as presented by the Appointed Actuary to his Board in April 1999. GAD had remarked on the Appointed Actuary's concerns that, in certain conditions (not a "worst case" outcome), "the position (of Equitable Life) would become impossibly tight" and expressed the view that worse results could arise if further "tweaks" were applied to these projections. Further information from Equitable Life was provided, and although this gave no comfort, nothing more of any substance was done on scenario planning until the meeting with Equitable Life on 18 July 2000, which was just two days before the judgment of the House of Lords.

6.15.4 We believe that closer and more informed scrutiny, at an earlier stage, of the financial implications of the possible outcomes of the Court case, which had been foreseen in the scenario planning, would have given the regulator more time to reflect on how to react appropriately to any courses of action proposed or taken by Equitable Life in response to any ruling of the Court. It was recognised that this could either have a materially adverse financial impact on Equitable Life or leave the PRE issue to be resolved by the regulator.

6.15.5 Following the Court of Appeal's ruling that Equitable Life's terminal bonus practice was unlawful, IFSD, in its analysis of the risks for Equitable Life and accordingly in its conduct of the company's regulation, appears to have focused too much on the *obiter* statements made by Waller LJ which suggested that Equitable Life was permitted to "ringfence". If the FSA had not placed such reliance on the statement of Waller LJ, it might have seen more clearly that the letter which Equitable Life had sent to its policyholders in February 2000, following the judgment in the Court of Appeal, required review to ensure it was not misleading. On the information available to us, we cannot and do not express a view as to whether the contents of this letter were misleading or not, but the letter should have been sent by IFSD to IB-PIA to be reviewed and discussed; in particular, IFSD should have raised with IB-PIA what action, if any, either of the regulators could or should take to protect the interests of policyholders. It may have triggered an investigation into whether other statements made by Equitable Life to potential policyholders at that stage were misleading.

6.15.6 That Equitable Life might lose as it did in the House of Lords first became a real possibility for which IFSD needed to plan in detail, at a very late stage, notwithstanding the fact that it had been identified earlier in the scenario plans prepared in the middle of 1999. As a result, IFSD was not prepared for the outcome in the House of Lords.

6.15.7 We would have expected IFSD to have adopted a more sceptical approach to Equitable Life's assertions about its prospects of success in the case and to have been

more proactive in considering the implications of the possible final outcome; in particular, even though, albeit late in the day, it appears that the FSA was aware on 4 July 2000 that Equitable Life had received an indication that it might lose in the House of Lords, it did not arrange an internal meeting to discuss the implications of this news nor was a meeting with Equitable Life arranged as a matter of urgency. In the event, a meeting only took place with Equitable Life on 18 July 2000 at Equitable Life's request by which time Equitable Life had already committed itself to the decision to put itself up for sale in the event that it lost in the House of Lords.

6.15.8 Representations have been made to us about the risks of a regulator being too interventionist and that a regulator's responsibilities are confined by the legislation to "allowing the company to determine its own strategy, intervening (whether by persuasion or by use of its statutory powers) only where that strategy was inconsistent with its regulatory obligations". We acknowledge that within the existing regime these are real constraints on actions which the regulator may otherwise wish to take, but we would add that a regulator also has to have regard to situations where there is a risk of a breach of the regulations.

6.15.9 We do not go so far as to suggest that the regulator should necessarily have intervened in this case, *i.e.* objected to Equitable Life's proposal to put itself up for sale but, in the meantime, to continue to write new business, as this would depend on there being appropriate grounds. In any event, the decision to allow it to do so was supported by valid reasons. But to be certain of making the right decision in the circumstances we do say that it is for a regulator to keep itself properly informed in such a situation. If the FSA had been better informed it would have been better prepared to react to any course of action proposed by Equitable Life and to assess its compliance with the regulations and the impact on the reasonable expectations of existing and potential policyholders.

6.16 The Bid Process

6.16.1 At the meeting on 18 July 2000 Equitable Life sought confirmation from IFSD that it would not take any "precipitous action" in the event that the House of Lords held that Equitable Life could not pay a different rate of bonus on GAO policies. Equitable Life noted particularly the importance of remaining open to new business in order that the value of the sales force was maintained. IFSD's response was to "reassure" Equitable Life that it would not rush to take remedial action in these circumstances although it would need to be convinced that a suitable buyer for the Society could be found quickly. It is not clear that the impact of this stance on policyholders, existing and potential, was given full consideration either ahead of this reassurance or immediately afterwards.

6.16.2 The FSA worked hard to ensure that all regulatory queries raised by potential bidders were answered promptly, but the FSA was subsequently surprised by the failure of Equitable Life to find a buyer. We consider that a lack of detailed financial information about Equitable Life (particularly as to the implications of the House of Lords' judgment), combined with over-reliance on statements made by Equitable Life and in the press, contributed to IFSD adopting an optimistic view of the saleability of Equitable Life both immediately preceding and following the House of Lords' judgment.

6.16.3 It should be said that most of the rest of the market shared IFSD's view and was also surprised by the failure of the bid process, but equally, at least at the outset of the bid process, IFSD had access to more information about Equitable Life's true financial state than the rest of the market and so it would not be unreasonable to expect the regulator to have a more informed view.

6.16.4 When it came to scenario planning for the House of Lords, we consider that, if IFSD had obtained from Equitable Life earlier more detailed financial information, including an analysis of PRE and had appreciated the implications of the entitlement in GAO policies to pay additional premiums, it would have been more alive to the possibility that no buyer would emerge and the resulting consequences for policyholders, existing and potential. As a result it would have been in a better position to react appropriately to any proposals from Equitable Life emanating as a consequence.

Conduct of Business Regulation

6.17 The Conduct of Business Regime

6.17.1 The conduct of business regime relates primarily to the marketing and sale of retail investment products and advising investors on their rights in relation to such products. The PIA Mission Statement defines the aim of the conduct of business regulator to be to "protect investors by the regulation and supervision of the retail investment sector, enabling investors to make properly informed decisions in an open competitive and innovative market place."[1]

6.18 Assessment: Conduct of Business

6.18.1 The issues concerning the GAOs were generally perceived by all at the FSA to be principally a matter for the prudential rather than the conduct of business regulator. The potential relevance of these issues for the PIA was identified and notified by HMT-ID to IBD soon after GAOs had been identified as a regulatory problem, in September 1998, but the significance of the matter was never picked up within IBD or IB-PIA at a sufficiently senior level for it to be accorded a suitably high profile. The supervision of the conduct of business aspects of the Equitable Life case which followed thereafter was impaired, both as regards procedure and substance.

6.18.2 We have attributed this to the lack of a suitably planned and structured approach and a poor level of communication and co-ordination between IFSD, IBD/IB-PIA and Enforcement. We also detected a reluctance by the staff to get involved and take "ownership" of the GAO issue. The consequence of this was that there was little or no continuity of management and an absence of any individual or team who would be responsible for seeing a matter through to its proper conclusion.

6.18.3 IB-PIA's responsibilities in this case are most conveniently dealt with by reference to the monitoring of the advice and information given (a) to existing GAR policyholders regarding the value of a GAO and (b) in relation to new investment in Equitable Life's with-profits fund.

6.19 Advice and information regarding the value of a GAR

6.19.1 The potential value of a GAR was a matter of material interest to a policyholder investing in a GAO policy either for the first time or subsequently by way of top-up.

6.19.2 The actual value of a GAR was also a matter of material interest to an existing GAR policyholder who was (a) considering switching his investment to a new product which would mean he would relinquish his entitlement to a GAR (such as a PFW) or (b) deciding whether and when to purchase an annuity at vesting.

[1]See PIA Press Release 1995 entitled "PIA Issues Report and Financial Statements for 1994/95" at Note 2

6.19.3 After the issue of the GARs first confronted it in 1999, IB-PIA subsequently came to the view that, until the uncertainties about matters concerning the GAR were resolved by the Court, there were no grounds for suspecting any breach of PIA Rules, and accordingly there was little for IB-PIA to do pending the outcome of the case. Some preliminary steps were taken to find out the size of the potential issue for IB-PIA, particularly given that most GARs had been sold well before the FSAct 1986 came into force, and how this product had been marketed. After the House of Lords had resolved the issue in a way which attributed a value to the GAR, the associated issues for the conduct of business regulator, which had been postponed pending the Court's decision, were not restored for further consideration.

6.19.4 Our examination of how IB-PIA (with Enforcement) reached its views and the steps it took discloses a process which was symptomatic of the lack of a planned and structured approach. Issues raised tended to be dealt with in isolation and other potential issues concerning advice and information about the value of the GAO were missed.

6.19.5 As to process, by January 1999 IB-PIA was aware of the problem. The memorandum of 20 January 1999 had identified the issues and suggested that the 'obvious first step' would be to find out the scale of the problem, in particular the number of sales which had occurred after the FSAct 1986 had come into force. But, apart from an inconclusive visit to the PIA Ombudsman and despite concerns raised by the Consumers' Association, nothing was done to follow through on the suggestions in the memorandum until in September 1999 IB-PIA was prompted to review this matter by the circulation of a note prepared by GCD explaining the decision of the Court of First Instance, which made some oblique references to issues for the PIA. It was only following this note that a meeting was arranged in October 1999 between representatives of all divisions of the FSA. This was the first such meeting dedicated to matters concerning Equitable Life.

6.19.6 At this meeting it was agreed that no action could be taken in respect of advice and information given to a GAR policyholder about the value of a GAR until the Court case was resolved but that the number of post "A" Day sales and top-ups should be ascertained. As a result of the meeting, for the first time, the number of post "A" day sales was elicited from Equitable Life by IFSD in correspondence. The information about the number of top-ups was not provided by Equitable Life nor pursued by IB-PIA.

6.19.7 The substantive decision taken in October 1999 was to seek information regarding the number of post "A" Day sales and top-ups but to postpone any review of the advice and information provided to GAR policyholders regarding the actual value of the GAO (whether at the point of sale or on vesting or switching) pending the outcome of the case. This approach was, in our view, correct. However, in the case of advice being given at vesting and on switching, IB-PIA's consideration of the issues was not sufficiently thorough because it did not take into account the further possibility that the uncertainty regarding the outcome of the litigation and the potential value of a GAO might itself be something which merited disclosure to a GAR policyholder. The PIA Rules require that representatives should, in the course of any relevant business dealings with an investor, give the investor all information relevant to those dealings and we take the view that the fact that the value of a GAO was the subject of a current court action was information which would be relevant to an investor who was deciding whether to vest or to switch.

6.19.8 We note also that, concurrently with IB-PIA's consideration of possible switching by Equitable Life of GAR policyholders out of GAO policies, Enforcement had themselves been tasked by the Board of the PIA to investigate Equitable Life's marketing of PFWs, which involved GAR policyholders relinquishing their entitlement to GARs. We understand that, for the same reasons as IB-PIA (i.e. that

advice to Equitable Life GAR policyholders about the value of a GAO could not be assessed pending the outcome of the case), this investigation was confined to switches from GAO policies issued by other life companies. However, no link appears to have been made between the possible switching of Equitable Life GAR policyholders and the Enforcement investigation. Subsequently, Enforcement did not provide IB-PIA with a copy of the investigation report produced in October 1999 until requested to do so in January 2000 and provided IFSD with no information on the matter until requested to do so in February 2000. Nor did Enforcement subsequently consider the potential impact of a decision against Equitable Life on the scope of the investigation.

6.19.9 After the House of Lords' judgment, when the uncertainty as to the value attributable to the GAOs had been resolved, the queries concerning the advice given about the GAR at the point of sale or when topping-up fell away. For GAR policyholders who had relinquished their GAOs on switching or vesting, there remained the possibility of an entitlement to compensation. The House of Lords' judgment did not trigger a review by IB-PIA of its earlier decisions to postpone consideration of these particular issues pending the outcome of the Court case. Furthermore, no steps were taken to consider whether the judgment might give rise to new issues for IB-PIA or Enforcement to address.

6.19.10 When IB-PIA did revisit the issue of post "A" Day sales, it was only as a result of being prompted by a chance misdirection of papers. As to the matter of compensation for those who had switched or vested, IB-PIA never raised this with Equitable Life or IFSD during the Review Period in order to satisfy itself that due consideration was being given to the structure of the GAR rectification scheme.

6.19.11 We accept that IB-PIA would normally be entitled to assume that, in the absence of any evidence to the contrary, a life company would provide adequate compensation to all investors so entitled. However, in the circumstances of such a high profile case as Equitable Life, where the potential compensation issues were so complex and where IB-PIA was told that the company's free asset base was weakened and that the solvency position was "tight", we would have expected IBD and IB-PIA to have sought some assurance from IFSD that Equitable Life was intending and able to provide adequate compensation to all classes of investors who were so entitled.

6.19.12 Equally Enforcement was not prompted to consider the impact of the House of Lords' judgment on the PFW investigation which continued on the basis that enquiries about the availability of a GAO were only relevant to GAR policyholders transferring from another provider. Nor did Enforcement take any steps to seek reassurance from IB-PIA that Equitable Life GAR policyholders, who had been switched out of GARs in the past, would be compensated as part of the rectification scheme. This is noteworthy because it was known to Enforcement that Equitable Life had stated that it would be inappropriate to review cases involving sales by Equitable Life of PFWs to GAR policyholders transferring from other providers.

6.20 Bonus Notices

6.20.1 The consideration by IB-PIA of the issues concerning information provided by Equitable Life to its policyholders during the currency of the policy (in particular bonus notices) illustrated the existence of what is, and was recognised at the time to be, a gap in the PIA Rules. This did, however, represent a matter of potential concern to both IFSD, which was responsible for PRE issues, and IB-PIA, which in the very broadest terms was responsible for certain communications between the life company and its policyholders.

6.20.2 There were exchanges between IFSD and IB-PIA during 1999 on this issue following a review by IFSD of the notices in the context of consideration of PRE. In

June 1999, IFSD asked IB-PIA to advise as to whether the presentation of the terminal bonus in the bonus notices issued by Equitable Life for 1996, 1997 and 1998 was misleading and whether the PIA had any powers to require Equitable Life to change these notices. IB-PIA informed IFSD that the notices were acceptable although, unhelpfully, did not disclose a countervailing view held by IB-PIA (Advertising) in respect of the 1996 notice. As to powers, IB-PIA reiterated the prevalent view within the FSA (independently confirmed by the conduct of business section of GCD) that the ongoing servicing of policies did not sit comfortably with the PIA's remit, which was confined by existing legislation to dealing, arranging deals, managing and advising on investments. We were told that, only if IB-PIA considered that there was a risk that documents being sent to policyholders were seriously misleading, would IB-PIA investigate the situation and consider whether it was possible to intervene (possibly by adopting an "influencing approach", rather than by reference to PIA Rules).

6.20.3 Notwithstanding the exchange that took place about this issue, we feel closer co-operation between IB-PIA and IFSD on the issue of bonus notices (and generally in relation to information provided to policyholders) would have enabled the regulator to have taken a more co-ordinated approach to considering and, if necessary, dealing with bonus notices issued by Equitable Life.

6.20.4 We recognise that the extent of the PIA Rules is constrained by the terms of the FSAct 1986. However, given that the regulator accepts that information provided to existing policyholders, such as bonus notices, can influence PRE and also trigger investment decisions by policyholders (such as deciding to top-up a policy), we question whether the exclusion of this sort of information under PIA Rules is consistent with PIA's statutory obligation to have adequate rules for the protection of policyholders. We understand that routine communications with policyholders, including bonus notices, will be covered under the new regime which will be implemented under FSMA 2000.

6.21 Advice and information in relation to new investment during the Review Period

6.21.1 Consistent with the aims expressed in its mission statement, one of PIA's responsibilities during the Review Period was to take appropriate steps to ensure that the advice and information being given to new investors was such as to enable them to make properly informed decisions in an open, competitive and innovative market place. One of the key questions concerning Equitable Life during the Review Period was the extent to which the outcome of the Court case would impact on the solvency margins of a with-profits fund with little estate and to what extent, being a mutual, liabilities owed to one class of policyholders would have to be funded by other classes of policyholders. While these were all principally a matter for the prudential regulator, IB-PIA ought to have satisfied itself that these issues did not give rise to questions concerning disclosure of information to new investors (in compliance with the PIA Rules which require a representative who has dealings with an investor to use his best endeavours to enable the investor to understand the nature of any risks involved).

6.21.2 Prior to the decision of the House of Lords and, in particular, immediately following the Court of Appeal judgment, IB-PIA was given comfort by IFSD in terms "we do not think that the judgment affects the statutory financial position greatly as Equitable Life already has to fully reserve …for biting GAOs". In the circumstances (and in view of the fact that it was by no means clear at that stage how the outcome would impact on the non-GAR investors in the with-profits fund), it seems reasonable that IB-PIA should merely, as it said it would, "keep a close eye on how things progressed".

6.21.3 Immediately following the House of Lords' judgment, IFSD informed IB-PIA by e-mail that the company was still solvent but that its asset base was weakened, which would affect the bonuses payable to with-profits policyholders, and that it had decided to put itself up for sale. A month later, at the bilateral meeting on 24 August 2000, IB-PIA was told that Equitable Life was just covering its solvency margin, but that the solvency position remained "tight".

6.21.4 As a result, when issues and complaints concerning advertising were referred to IB-PIA after the House of Lords' judgment, IB-PIA agreed with the approach adopted by IFSD which was that the company was solvent and there were therefore no legitimate grounds at that stage to seek to suspend the company's advertising activity.

6.21.5 We acknowledge that, once the decision had been taken by the prudential regulator, who had primary responsibility for the assessment of the potential financial impact of the case following the House of Lords' judgment, to allow Equitable Life to continue to write new business, it would have been inconsistent with that decision to require Equitable Life to suspend advertising or to require it to give any special health warnings to new investors about the operational risks faced by it. However, given the delicate financial state in which Equitable Life found itself following that ruling, we consider that throughout this period IB-PIA should have been alert to the need to monitor both:

(a) Equitable Life's advertising; and

(b) information and advice being given to new investors,

to ensure that they complied with the PIA Rules and, in particular, that they were clear, fair and not misleading.

6.21.6 IB-PIA did receive further reassuring messages from IFSD that the company was solvent and there was no reason why it could not continue to advertise. As a result of this, IB-PIA concluded it would "keep an eye on this issue". We note however that within a week Equitable Life had withdrawn its advertising campaign.

6.21.7 We also believe that more active consideration should also have been given by IB-PIA as to the effect on existing non-GAR policyholders of GAR policyholders making further investments in the with-profits fund by means of top-ups and the need to monitor what, if anything, Equitable Life was saying to its new policyholders about this.

6.21.8 This is illustrated by the fact that, on 17 November 2000, IFSD raised with IB-PIA the possibility that (a) GAR policyholders might seek to top-up their policies as much as possible in order to maximise the value of the GAR; (b) that this was "likely to shift the Equitable Life GAR liability significantly upwards" and (c) that additional payments made by non-GAR policyholders would be used to subsidise GAR policyholders. IB-PIA never properly considered the nature of the advice that should be given to non-GAR policyholders about the liability for GARs. Nor did IB-PIA contact Equitable Life to make enquiries about what advice had been given about this or to discuss it further with IFSD after getting advice from IB-Policy to the effect that, if the company could not "promise" asset share, then investors would have to be warned that they "could get back less".

6.22 Management Issues

6.22.1 In May 1999, it was suggested that someone be nominated to take forward the issue raised by the Consumers' Association and, in September 1999, there was a further recommendation that a small team be established to gather relevant information.

Neither of these suggestions was implemented as part of IB-PIA's subsequent consideration of the particular issues. Although the particular issues in each case were taken forward within IB-PIA, in general, the lack of a single point of contact for all GAO issues adversely affected IB-PIA's ability to liaise effectively with IFSD and deal properly with new issues as they arose.

6.22.2 Throughout the Review Period, IB-PIA made relatively little use of the actuary employed by IBD. This resource might have been able to provide useful input in relation to areas of common interest between the prudential and conduct of business regulators and might have provided a useful point of contact between IFSD and IB-PIA.

Co-ordination

6.23 Management Issues

6.23.1 We have attributed the deficiencies which we have identified in part to what we describe as a poor level of communication and co-ordination between the two 'arms' of regulation. We have sought to identify where this went wrong.

6.23.2 We acknowledge that steps were, and are, being taken more generally within the FSA to improve the co-ordination between its constituent parts. In particular, we welcome the FSA announcement in its Plan and Budget for 2001-02 of its plans to integrate prudential and conduct of business regulation. We also welcome the steps which have already been taken by the FSA to bring actuarial expertise "in-house" by arranging the transfer of the relevant teams from GAD to the FSA.

6.23.3 We also recognise the steps which were taken to improve inter-division communications such as lead supervision. But this initiative was in its formative stage during the Review Period and there is no evidence that, in relation to the Equitable Life episode, it served to improve, in any material way, the level of communication about the issues arising in that case.

6.23.4 In relation to the management of the Equitable Life GAR issue, we feel that an opportunity was missed at the outset to ensure that a properly co-ordinated "new style" approach was adopted to managing a problem which was clearly high profile and which obviously crossed the boundaries between prudential and conduct of business regulation. This could have been achieved by forming a team which included representatives from all relevant divisions within the FSA, supported by the necessary expertise. This is particularly noteworthy given that it was recognised within FSA that the level of communication between these two regulators had, in the past, been negligible and was in need of improvement.

6.23.5 We would have liked to have seen evidence of an initiative being taken at an early stage and at a sufficiently senior level within the FSA to get the two regulators and the relevant in-house specialist advisors around a table to "brainstorm" this matter and make the necessary arrangements for this matter to be managed appropriately thereafter. We consider that such a meeting would have assisted in ensuring that each of them was well briefed on the other's functions, duties and requirements; would also have helped to raise the profile of the issue in the minds of the conduct of business regulators who, in our view, never fully appreciated the scale of the potential problem both in monetary and reputational terms; and would have saved time and avoided duplication.

6.23.6 It is significant that, although there was a series of routine bilateral meetings between IFSD and IB-PIA at which reports were given on the Equitable Life matter, the first

(and only) meeting dedicated to the Equitable Life matter which was attended by the two regulators and also by the Enforcement team did not take place until 21 October 1999, more than a year after the issue was first recognised.

6.24 Exchange of Information

6.24.1 While there is evidence of IFSD seeking to keep IB-PIA informed of certain matters, particularly the progress of the Court case, we have identified a number of examples, throughout the Review Period, of inadequate co-ordination or lapses in the exchange of information between the prudential and the conduct of business regulators. For example, we think it would have been helpful if IB-PIA had been included in the meeting to discuss the scenario planning which was held in June 1999. It would also have been better to have included IB-PIA in the discussions following the House of Lords' judgment so that views on how to manage the issues about sales after that decision and, in particular, whether and how these should be monitored, could have been properly co-ordinated. Finally, we would have expected to see some liaison between IFSD and IB-PIA as to the scope of Equitable Life's proposed rectification scheme.

6.24.2 There is evidence, particularly in the context of bonus notices, that neither of the two regulators fully appreciated the issues which the other was required to address and the information which the other would find useful; and neither was properly and consistently aware of what the other was doing.

6.24.3 This poor level of communication and co-ordination between IB-PIA and IFSD contrasts with the closer and more effective liaison which IFSD had with GAD with whom it obviously had a longer standing and more mature connection, notwithstanding the fact that they were operating from different locations. Familiarity with the others' roles and responsibilities is as important an ingredient of successful integration as working under the same roof.

Chapter Seven

Lessons to be Learned

7.1 Introduction

These recommendations are directed at the regulation of the life insurance industry. The FSA Board, as it moves towards the formation of the single regulator, may wish to consider whether these apply to other areas of regulation (or may, indeed, be constrained by such), but we are only in a position to make specific recommendations in respect of the life insurance industry.

In making these recommendations we acknowledge:

(a) the scale of the task of creating a single regulator, and the constraints and inhibitors to the introduction of change imposed on the FSA by the transitional regime;

(b) that, where appropriate, the FSA will have to follow the requirements of its established practice of consultation and cost benefit analysis, to ensure that any proposed changes have regard to the statutory principles of proportionality, economy and efficiency; and

(c) that the FSA will also have to have regard to the desirability of maintaining a "level playing field" for those whom it regulates and who also form part of a wider international insurance and financial services industry and operate in an internationally competitive environment.

The Regulatory Structure

7.2 Solvency standards

The current prudential framework for life assurance companies does not adequately reflect the nature, diversity or scale of the risks in the business.

We recommend that the current framework needs to be restructured so that the required minimum capital reflects all the risks in the business.

It is proposed that, in the longer term, fair value accounting will provide the basis for statutory accounting. This, together with risk-based capital measures, would provide an appropriate solvency framework. There would be significant advantages in both transparency and cost in having such a common basis.

However, the introduction of such a framework will take some time to achieve, not least because of their need to reach agreement with other European regulators.

Therefore, **some interim measures** are required, which themselves may need phasing in because of their financial impact on individual companies.

7.2.1 Guarantees and options within policies

As has been described in this Report, the issues of the timing and level of reserving for the GAOs were central to the problems of Equitable Life. We recognise the need to consider the effect on the prudential treatment of guarantees and options elsewhere in financial services, but we believe the current rules for life insurance companies are inadequate.

We recommend that financial guarantees and onerous options in life insurance policies should be valued stochastically and consistently with traded option prices in the market.

7.2.2 Future profits implicit items

The regulator has discretion over whether to grant Section 68 Orders which allow future profits to count towards solvency, but has long indicated that such concessions will be readily available. Equitable Life made extensive use of future profits implicit items over a number of years. This allowed it to meet the minimum solvency requirements and to improve the external perception of financial strength. Taken together with its subordinated loan facility and the financial reinsurance arrangements, there was the possibility that potential investors could have been misled as to Equitable Life's true financial strength.

We recommend that the exercise of discretion over the use of implicit items should be reviewed.

7.2.3 Financial reinsurance

The current solvency regulations define provisions that contain prudent margins. These margins provide an opportunity to arbitrage against economic reality particularly through the use of some forms of financial reinsurance. This arbitrage undermines the margins of prudence in the current solvency framework and could pose a threat to the financial system.

We recommend that a review be undertaken of the extent to which the financial strength of the industry is eroded by the amount of such financial reinsurance in place.

We also recommend that full disclosure of these arrangements, including the material contingencies to which they are subject, should be made in the regulatory returns.

7.2.4 Control levels

The regulator has commented that its powers of formal intervention are, in some areas, restricted by a requirement that the required minimum margin of solvency is breached before any direct action can be taken.

We recommend that the regulator review the possibility of introducing multiple control levels as a basis for triggering proportionate regulatory action.

These might include, for example, the ability of the regulator to require independent investigations, reports or plans to be created where an insurer provides substantial investment guarantees and or its free assets fall below some multiple of the required minimum margin.

7.3 The role of the Appointed Actuary

The Appointed Actuary system has worked well for a long time. However, the reliance on one individual with no external, detailed check of his work inevitably poses risks.

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

7.4 Disclosure

The framework of the regulatory returns was designed many years ago to allow the regulator and other market professionals to review the assumptions and bases adopted by the Appointed Actuary when valuing the liabilities. Although the regulations and guidance have been amended, the disclosures required have inevitably lagged behind developments in the industry.

In addition, the current regulatory returns merely provide a snapshot of an insurer's financial strength at a point in time. This does not give a clear picture either of the financial trends of the insurer or of the risks to which it is exposed.

We recommend that the purpose, content and frequency of the regulatory returns be reviewed. The information provided by all firms must be both timely and sufficient to assess the risk of customer detriment which might arise from issues relating to either solvency or PRE issues.

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

The regulator must also have the ability to obtain further relevant information when appropriate, and perhaps routinely for higher risk firms, and may want to conduct its own review in appropriate circumstances.

We believe that this information could include, for instance:

(a) changes in free capital, identifying material changes in the methodology or bases of valuing liabilities and divergences from assumptions;

(b) how claim values satisfy PRE including the development of asset shares and how these relate to claim values;

(c) quantification of guarantees, options and all other potentially material contingent liabilities; and

(d) other information in a revised "Financial Condition Report" which should include analysis of expected financial trends, use of stochastic modelling where appropriate and the possible effects of environmental developments in areas such as politics, the law and the environment.

It is recognised that some of this information is commercially very sensitive and could have a destabilising effect on public confidence, if published. The FSA will have to consider how to strike the right balance between (a) preserving the confidentiality of such commercially sensitive material in the interest of maintaining financial stability; (b) operating in a preferedly transparent manner; and (c) satisfying consumer information requirements through meaningful public disclosure.

7.5 Industry review

The information obtained under 7.4 above would facilitate a deeper understanding within the FSA of the operation of the insurance industry.

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

7.6 Introduction

It is acknowledged that the role, style and approach of the FSA has been the subject of review, consultation and reform since 1999. The Review Team has seen no evidence to suggest that any aspects of the proposed new approach need to be reconsidered. However, we do recommend, in the light of what we have seen occur in the context of Equitable Life, that the FSA satisfies itself that, in a certain number of respects as identified below, the new approach has been adopted and is being applied in practice.

The lessons to be learned under this heading fall into three broad categories: culture, process and tools.

7.7 Culture

The Review Team's impression of the style of the prudential regulation of the long-term insurance industry inherited by the FSA, when compared with its prudential regulation of the banking industry, is that it is less intrusive and involved. While the FSA is understandably concerned to guard against unnecessary intrusion into firms' businesses or being seen to influence inappropriately management decisions, and particular concerns have been expressed in this context about the consequences of the regulator acting as a shadow director, it should also be recognised that the management of a life company may have a number of competing interests to balance, only one of which will be the interests of their policyholders, both current and prospective.

We therefore recommend that the FSA, in its regulation of the long-term insurance industry:

- **where appropriate to do so, be prepared to act more proactively in pursuance of its statutory objectives to ensure that the interests of customers are properly protected;**

- **forms and articulates a clear view of what are the permissible boundaries of proactive regulation;**

- **reviews its approach to the use of its powers of investigation, influence and intervention so that it acts in a way proportionate to the perceived risks; and**

- **adopts a more proactive, risk-based approach so that the frequency, depth and breadth of contact with firms is related to the risk category of that firm.**

The Review Team recognises that these recommendations are in line with the FSA's stated intentions.

The Review Team has detected a culture within IB-PIA in which there is little appetite and capacity to examine the wider implications of an issue and a reluctance to pursue any matter without clear evidence of a breach of the Rules. We believe that this is born of a need to prioritise relatively scarce resources and may be appropriate when dealing with the mass of routine work for which it is responsible. But this approach is inappropriate when dealing with a high profile and reputationally sensitive cases such as Equitable Life. More encouragement to IB-PIA staff "to spot and tackle" the issues would serve to move this culture away from what appears to be very much a rule-based regime to one more aligned with the FSA's new risk-based approach.

It is not necessary for us to make a specific recommendation in this regard as we believe this concern is sufficiently addressed by the other recommendations we have made.

There was limited communication and poor co-ordination between divisions of the FSA regulating the life industry. As a consequence, there was a lack of awareness about what issues the different teams needed to address.

We recommend that the FSA devotes more resources to developing internal awareness between teams both as to what functions each team performs and the information each team requires to assist it to do its job. We welcome the FSA's creation of one division, comprising prudential and conduct of business regulators and GAD, to deliver integrated supervision of the insurance industry.

7.8 Process

The Review Period covers the very early days of the integration of the regulatory structure. In the case of Equitable Life, some of the newly adopted procedures and systems did not work.

Wholly integrated regulation of the insurance industry is being introduced. The FSA should remain alert to the difficulties of implementing change and, in particular, be alive to the risk that such structural change may facilitate better communication and co-ordination within the FSA, but it will not necessarily achieve it.

When any matter emerges which is of a certain size and scale and/or has potentially significant reputational issues, the FSA management should not assume that the existing team structures will deliver the required result.

We recommend that in such cases, the FSA management take steps to ensure that:

- **the existing team structure includes all those with a relevant interest in and the necessary expertise concerning the matter; or**
- **a special team is formed to handle the matter; and**
- **in both cases, the team is properly constituted with persons with the necessary expertise and knowledge and thereafter works cohesively exchanging all relevant information and managing issues in a consistent and comprehensive way.**

In a situation where customers' interests are damaged or put at risk, such as in the case of Equitable Life, there is always a sense on the part of customers that the regulator has failed them. The Review Team recognises that this will probably always be the case. The publication "A New Regulator for the New Millennium" seeks to promulgate the message that the objective of maintaining market confidence does not imply "aiming to prevent all collapses or lapses in conduct in the financial system."

We recommend that this message be reinforced by making it clear to customers that non-intervention or no comment by the FSA, where a company's difficulties are attracting press coverage, should not be taken as an endorsement of the company's financial well-being.

The Equitable Life episode has revealed uncertainty about the interpretation of the conduct of business rules and the standards of disclosure that should be expected of firms where customers are potentially exposed to significant operational risks (as opposed to the more common investment risk), such as Equitable Life losing the Court case.

We recommend that the FSA considers what standards of disclosure should apply in this area and the extent to which these can be codified.

The role of Enforcement in the matters under review deserves some attention. The Review Team's impression was that once an issue had been referred to Enforcement, there was limited communication between the investigating team and the team responsible for monitoring Equitable Life. This is partly due to the complex interim structure which prevails pending the implementation of the FSMA 2000. However the lack of effective interaction between the regulator and Enforcement during the currency of the investigation meant that the opportunity to use Enforcement as a source of information regarding Equitable Life's treatment of policyholders was lost and the implications of the House of Lords' decision on the investigation were never fully considered either by Enforcement or IB-PIA.

We recommend that steps be taken to rectify the shortcomings and, in particular, to ensure that information in the hands of the Enforcement team is made available to the regulator and vice versa in a timely way in order to improve management of the matter and thereby overall consumer protection.

In the context of long-term insurance business, the prudential regulator has responsibilities relating to PRE and customers' interests, which are created and shaped by communications with policyholders. This represents a matter of potential concern, which it shares, with the conduct of business regulator who has responsibility for ensuring that relevant communications with customers comply with its rules. In the context of the Equitable Life case, this area of common interest was not effectively managed.

We recommend that as part of the integration of these two regulatory divisions, the FSA takes steps to ensure that responsibilities in this area are comprehensive and properly co-ordinated and managed.

7.9 Tools

Throughout the Review Period, a principal focus of the regulator's attention was directed at ensuring that Equitable Life would continue to be able to meet its statutory reserving requirements. There was very little, if any, assessment of the financial implications to Equitable Life of losing the case and the consequential impact on existing and potential policyholders. We commend the FSA's stated aim of identifying, assessing and prioritising risks, both in the sense of grading firms and assessing the potential impact of and likelihood of industry-wide risks. This risk assessment would be enhanced by discussion with the insurer's own risk management function and its internal and external auditors.

We recommend the FSA gives consideration as to how to apply a more rigorous risk assessment process to specific situations where certain risks have escalated or crystallised, and where it is particularly important to plan for all reasonably considered outcomes. We welcome the FSA's stated intention to adopt a more proactive risk-based approach so that the frequency, depth and breadth of contact within firms is related to the risk category of that firm.

'PRE' is a statutory concept without a definition. Apart from the ministerial statement, which sought to give guidance as to the factors to be taken into account in determining PRE in respect of the attribution of surpluses in with-profits funds, there is no universally accepted framework to assist those with the responsibility for assessing it. With the introduction of the new prudential sourcebook, PRE will be subsumed within the FSA principle that "a firm must pay due regard to the interests of its customers and treat them fairly".

We recommend that in situations where regulators have to have regard for concepts such as PRE, which are undefined or capable of more than one interpretation, FSA should develop policy templates so as to ensure consistency of interpretation and application across the regulatory process.

In particular, we encourage the FSA to carry through to completion its current work on clarifying the meaning of customer interests and PRE.

The old style and approach to the regulation of the long-term insurance industry, which was operating during the Review Period, is to change at N2. As the FSA introduces "the New Regulator for the New Millennium", additional resources will be needed if it is to bring the prudential regulation of insurance companies more in to line with the prudential regulation of banks and building societies. The crude comparator of "staff resources deployed per institution regulated" shows banks and building societies having more than double the resources of those that are deployed on life insurance companies. When the one-off tasks involved in preparing for N2 are substantially complete, more resources will become available for "business as usual" regulatory activity. However, this is unlikely to fill the envisaged gap in additional resources required.

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

We acknowledge that the FSA has already taken steps to address this by introducing in-house actuarial expertise with the transfer of the relevant staff from GAD to the FSA and the commencement of the integration of prudential and conduct of business regulators.

7.10 General

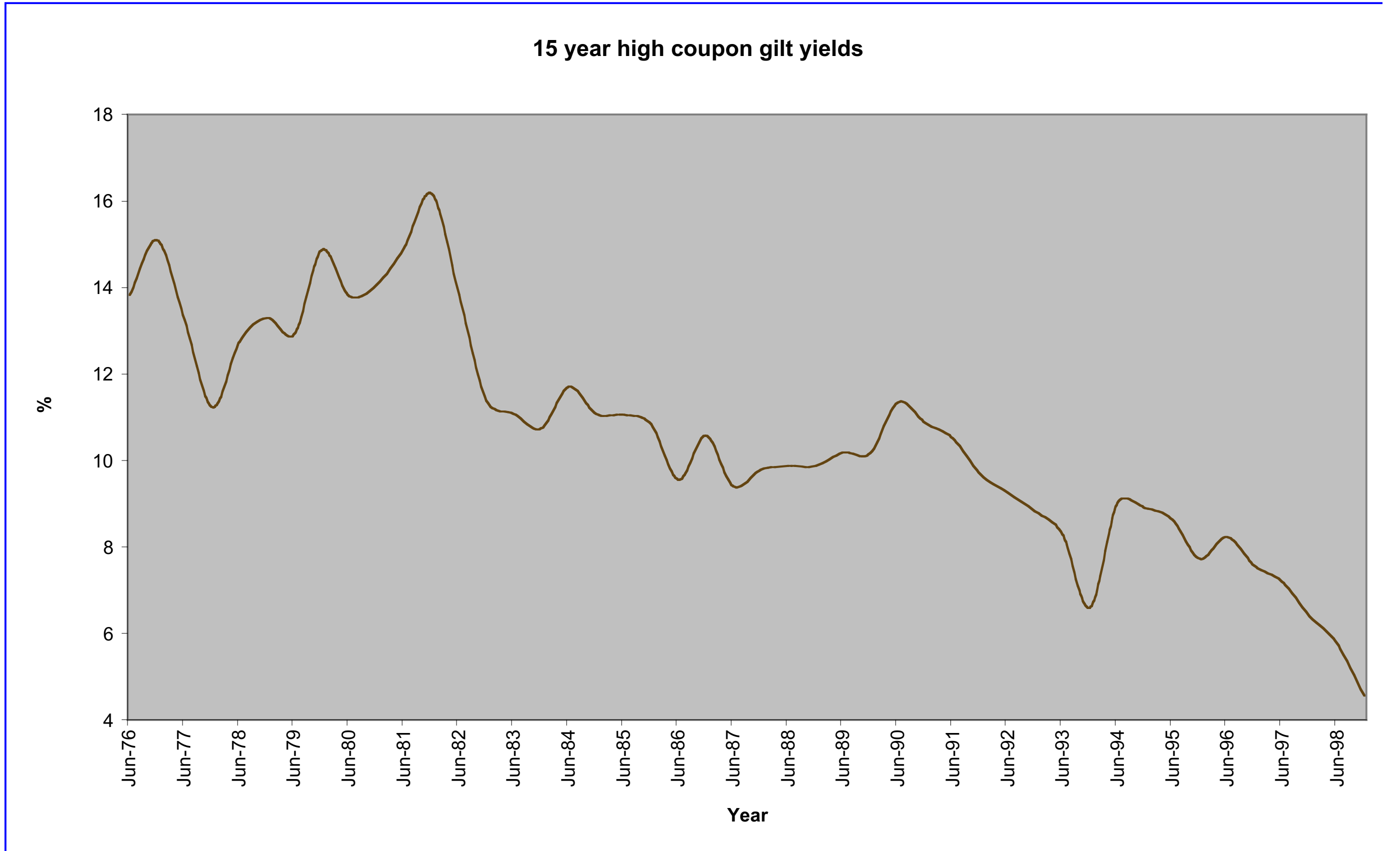
The Equitable Life case has industry wide implications. Our Terms of Reference have allowed us only limited insight into the FSA's consideration of these. There are issues and FSA initiatives which have continued beyond 8 December 2000 which have not been examined by the Review Team. Accordingly, we are not able to comment on the sufficiency of these exercises.

We mention this only to say that we would expect the FSA to have progressed such exercises.

Appendix 7

Gilt Rates

This graph shows levels of 15 year high coupon gilt yields from 1976 to 1998. The steep drops around 1993 and 1999 correspond with drops in annuity rates at those times.

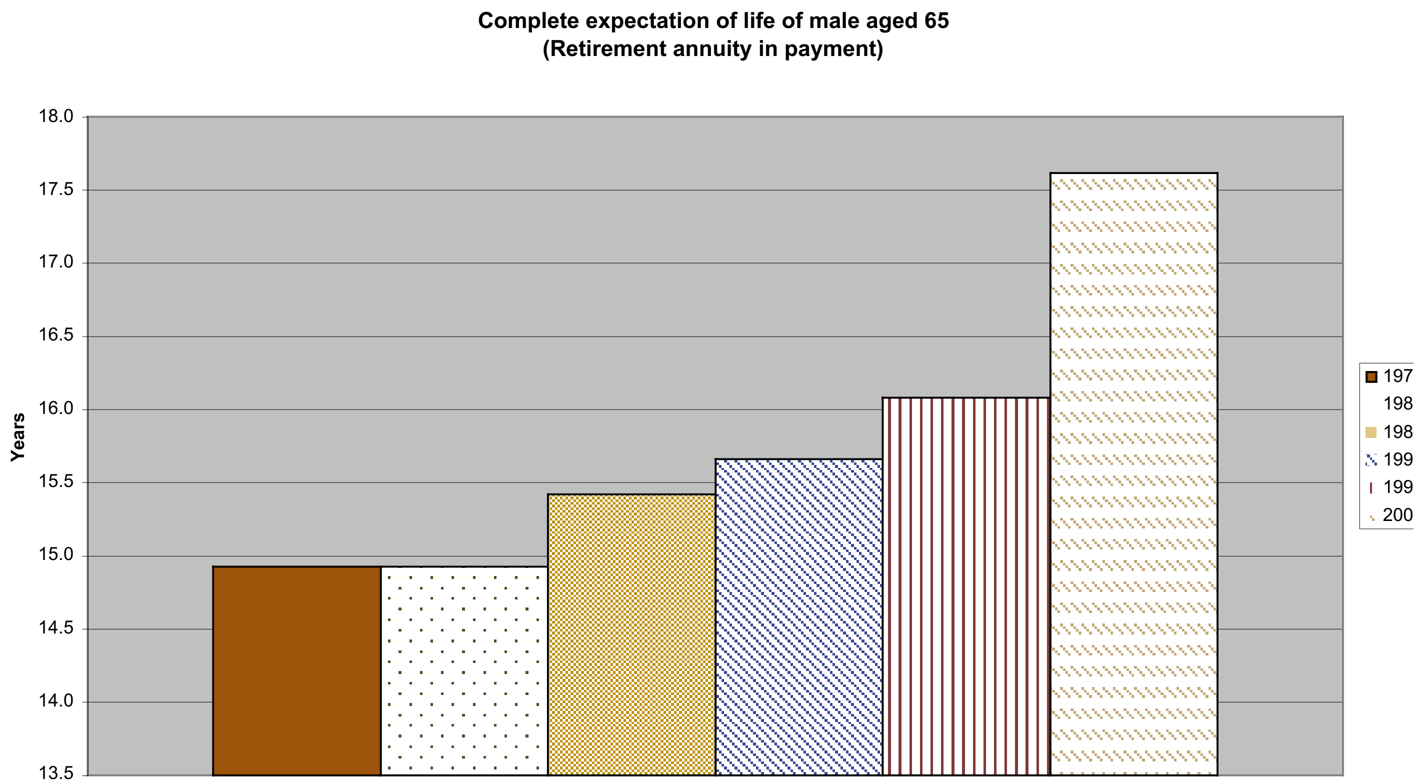


Appendix 8

Mortality Rates

This chart shows, at five-year intervals from 1975 to 2000, the life expectancy of a 65-year-old male holder of a retirement annuity policy in the course of payment. The expectancies are based on mortality rates derived from Continuous Mortality Investigation Bureau reports, which would have been available to life insurers at the given dates.

The chart shows that life expectancy has increased in recent years, which would have contributed to the decline in annuity rates.



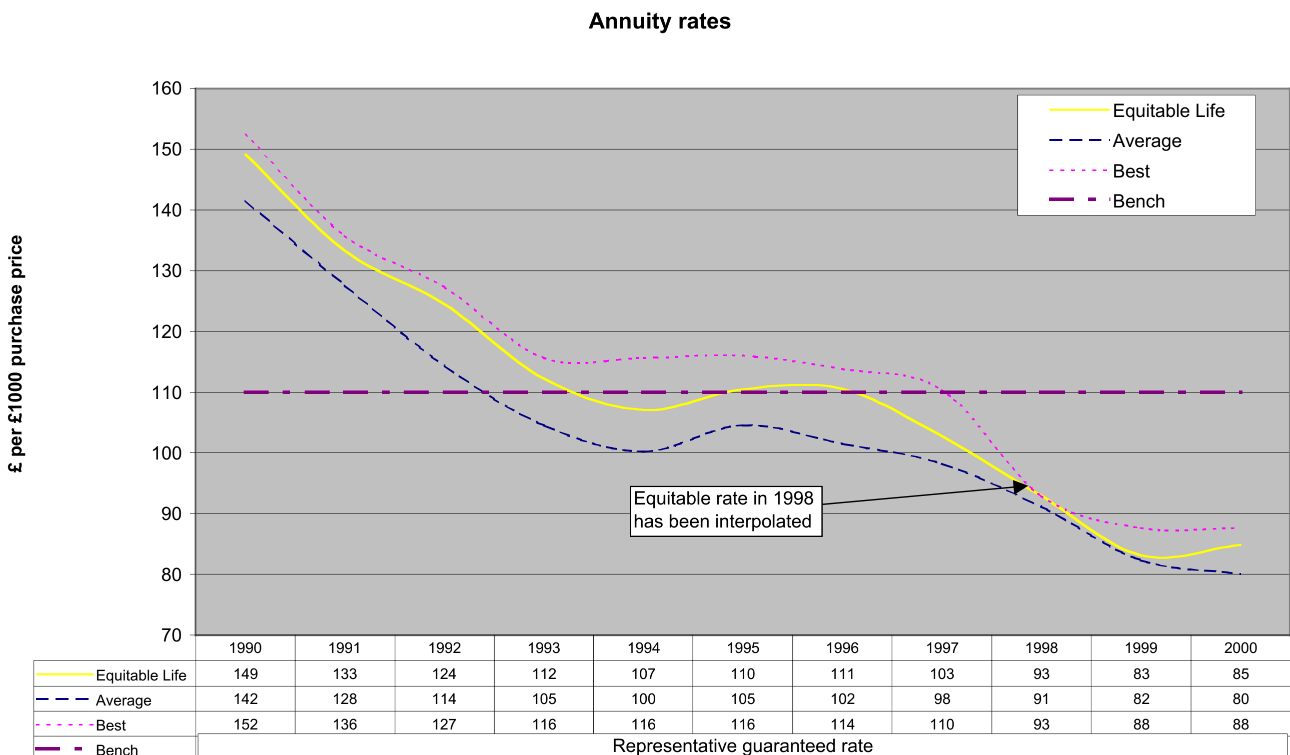
Appendix 9

Annuity Rates

This graph provides an indication of the total annuity payable annually per £1000 purchase price from 1990 to 2000. The graph includes rates for Equitable Life and the best and average rates from the top providers each year. Since no comparable rate was available from the sources researched, the 1998 rate for Equitable Life has been interpolated from the rates for adjacent years.

Equitable Life offered a number of different levels of guarantee at different times. The guaranteed rate included in the graph is representative of a typical guarantee.

The graph shows that the value of annuity payments dropped below the representative guaranteed rate offered on some Equitable Life policies.



	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Equitable Life	149	133	124	112	107	110	111	103	93	83	85
Average	142	128	114	105	100	105	102	98	91	82	80
Best	152	136	127	116	116	116	114	110	93	88	88
Bench	Representative guaranteed rate										

Appendix 10

Year	**Date of Application**	**Amount applies for**	**Est. future profits (*retrospective calculation)***	**Amount granted**	**Amount used in Returns**
1994	15.12.94	£500m	£2,141m	£500m	£250m
1995	28.06.95	£500m	£1,163m	£500m	£264m
1996	26.06.96	£600m	£2,213m	£600m	£313m
1997	30.06.97	£700m	£2,252m	£700m	£371m
1998	26.06.98	£850m	£2,674m	£850m	
	22.12.98	£1,900m	£2,674m	£1,900m	£850m
1999	14.10.99	£1,000m	£2,960m	£1,000m	£925m
2000	27.06.00	£1,100m	£3,304m	£1,100m	