

PART VII: CONCLUSIONS AND LESSONS**CHAPTER 19: CONCLUSIONS**

1. In this chapter I will outline briefly the events recounted in this report relating to the Society and its actions, before discussing the roles of the Board, executives and auditors of the Society, and then the regulatory regime and how it was applied in the case of the Society. I will deal with some of the more significant representations I have received as I do so. At the end I will highlight some of the central conclusions and turn to the lessons that might be drawn for the future.

2. As throughout this report, I have not qualified my comments by reference to professional standards current at the time events occurred: that is a matter for the courts and professional bodies exercising disciplinary functions. Further, I have the benefit of hindsight, and I have not restricted the comments made to those matters that can be shown to have been within the knowledge or contemplation of individuals or groups at material times. In seeking material from which lessons can be learnt for the future it would be impossible to restrict oneself to what individuals knew or ought to have known at any time in the past. The lack of knowledge may itself be an important source of material pointing to lessons for the future.

The Society

3. Until the early 1970s the Equitable Life was a relatively small, conservative life office servicing a narrow market. The bulk of its business was generated by the FSSU, an endowment-based pension scheme for university teachers that required little in the way of marketing and management, and was of its nature aimed at an intelligent and articulate clientele. This appears to have insulated the Society from general competitive pressures.

4. However, from the mid-1960s the Society faced the prospect of the loss of FSSU business as proposals to update the tax treatment of pension schemes generally began to be discussed¹. The necessary legislation was passed in 1970 and from 1975 new university business declined rapidly. The end of the FSSU presented the Society with a dilemma: it had to find a new market and adopt a more active marketing stance to develop business to substitute for FSSU, or face decline as it serviced a diminishing book.

5. The Society elected to embark on active marketing, and adopted a series of strategies aimed at increasing market penetration. The Board decided to target the upper end of the market, with which the Society had some familiarity. Increasingly sophisticated marketing strategies were developed in the late 1960s and early 1970s. The Society developed its own dedicated sales force and branch network. The executive developed new products designed to be attractive to that market. And they developed a range of distinctive features that could be said to distinguish it from the competition.

6. Three distinctive features are of note. First, the Society marketed on the basis of high levels of service provided to policyholders, both in terms of the highly flexible products on offer, and in terms of ancillary financial and tax advice provided. Second, there was a consistent emphasis on low expenses, in absolute terms and by comparison with the industry, and the absence of commission paid to third parties. There are issues about whether the advertised ratios in the 1990s were over-influenced by the Society's practice of treating policy switches before and at maturity as claims and new business simultaneously, and whether the deliberate reliance on direct sales may have insulated the Society to some extent from direct comparison at

¹ See chapter 3 and Appendix C.

the point of sale. But the Society seems to have been generally successful in sustaining a low expenses policy. Third, and central to the Society's projected image, was the emphasis on mutuality and the two benefits the Society proclaimed as inherent to its mutual constitution: no shareholders to take a share of returns, and the members' ownership of the business.

7. A corollary of the absence of shareholders as competitors for the Society's assets and profits was the absence of a source of external finance in case of need. The Society made a virtue of this by developing and advertising the theory that the with-profits fund was the source of working capital for the development of the business, and was remunerated for the capital risk it undertook by the allocation of part of the resulting profit to policyholders on maturity. In this way current generation policyholders supported new-generation policyholders, but were rewarded in due course from the profits generated by the new business. The mechanism by which the reward was returned was not explicit, and the theory of capitalisation for growth from policyholders' contributions was controversial.

8. The members' ownership of the business was also significant to the manner in which the Society was run. It was expressed in and after the late 1980s in the total allocation policy: current surplus was not held back for later generations of policyholders. Policyholders were encouraged to take the view that the Society's practice was to allocate all available surpluses as they arose, subject to a degree of smoothing, in contrast to other offices that withheld benefits that should have been available from current surpluses. This approach, and the absence of a free estate, was presented as being a continuation of an approach that dated back to the establishment of the Society in the 18th Century, although this was part of a mythology that was build up over the period covered by this inquiry. In fact the Society's reserves, in off-balance sheet capital appreciation and hidden margins in liabilities, amounted to over 40% of its long-term liabilities at the end of 1972, and following the adverse market conditions of the mid-1970s, the Society briefly set about building up reserves of free assets again until the early 1980s.

Origin of the Annuity Guarantees

9. In Maurice Ogborn, the Society had until 1972 an actuary in the historic mould, highly regarded and innovative. As second in command to Henry Tappenden, and then as 'the Actuary', who under the Society's constitution was the chief executive, Ogborn was responsible for developing a contract form with a range of core features that readily lent themselves to adaptation to changing market demands.

10. In 1956-57 Ogborn developed the Society's original with-profits retirement annuity form of contract on the basis of a pre-existing recurring single premium endowment policy². However, it did not initially form a major part of the business. At the quinquennial valuation of the fund at 31 December 1961, the main classes of business were whole-life and endowment assurances. The retirement annuity policy (RAP) did not begin to make a significant impact until the next decade.

11. The design of the product was to become important with the growth of business. The RAP was designed to fit in with the use of a common rate of return to policyholders across the with-profits fund along with other business and in particular endowment business. Endowment business at the time was sold on premium bases that allowed for an implicit guaranteed investment return (GIR), with the premiums loaded for profit in addition. Those characteristics were incorporated into the new RAP.

12. The Society's FSSU contracts had provided that the endowment fund built up to maturity could be applied to purchase a pension in annuity form. The Government effectively underwrote the pension element to ensure that the recipient obtained on retirement a minimum pension related to length of service. In addition

² See chapter 2.

to these particular features, related to wider fiscal policy, the Society offered FSSU contract forms that provided a guaranteed annuity option at maturity. For this additional benefit the Society charged an additional premium.

13. In developing the RAP form Ogborn introduced some specific features that came to characterise pensions business until 1988:

- i. Conversion rates were guaranteed in the contract for the whole duration to maturity in every case. (It is this conversion rate that has generally been identified as the guaranteed annuity rate or GAR³.) The cost of this benefit was known from FSSU experience.
- ii. The policyholder was free to make contributions on pre-determined terms of a value greater than any contractual minimum, subject only to Inland Revenue limits.
- iii. There was flexibility in the selection of pension age.
- iv. There were contractual options available to the policyholder, but the primary obligation of the Society was to pay the specified annuity.

Despite subsequent claims to the contrary, there is persuasive evidence that the cost of the annuity guarantee was incorporated into the RAP premium bases⁴.

14. The annuity guarantees reflected in the annuity scale incorporated into the contract were initially based on a low rate of investment return, of 2½%, later increasing to 3%. In October 1975 the rate was increased to 3½%. The implicit interest rate component in the conversion rate in possession, originally 4%, was increased in October 1975 to 7%.

15. The increases in the investment rate and the conversion rate reflected the generally upward trend in interest rates until the mid-1970s. In the 1980s, however, when market rates began to fall, the Society did not revise the investment rate or the conversion interest rate implicit in the contractual guarantees in response.

16. Until the mid-1970s, the Board supplemented the guaranteed annuity to a level related to current immediate annuity rates, reflecting the inherently conservative levels of guarantee implicit in the contract. There was, before 1973, no terminal bonus policy in place, and the device of a discretionary final annuity bonus or adjustment enabled the Society to overcome one of the limitations inherent in a fixed guarantee: that it depressed returns in good market conditions. That policy of supplementing the annuity rate was superseded a few years later, when terminal bonus had become part of the Society's normal bonus structure and was seen to provide the flexibility the Actuary wanted to adjust total returns.

17. As fiscal legislation developed, the Society provided a commutation option, and later an open market option in existing and in new contracts. The commutation option, which was introduced in 1971, required the Society to break down the annuity guarantee into two stages, each reflecting two of the underlying actuarial assumptions that had implicitly characterised the original design of the contract by Ogborn, and the distribution policies that had been developed around them:

- i. Commutation rates were adjusted to ensure that the benefit of the final bonus adjustment designed to uplift the guaranteed annuity to current annuity rates was not available in cash form;
- ii. The net conversion rate in possession could then be used to express the appropriate part of the annuity as a cash sum;
- iii. The elements of the total guarantee reflected in the conversion rate on commutation were the implicit interest rate, 4% or 7% according to generation, and the mortality assumption applied at inception;

³ See foreword for discussion of this terminology.

⁴ See chapter 2, paragraphs 16 to 23.

iv. It became possible for financially sophisticated observers to identify the net effect of the implicit expenses deduction and the investment roll-up rate applied in computing the guarantees.

18. The process of development was carried further when the open market option was introduced in 1978. Policy forms were altered to make explicit in separate tables the accumulation of premiums net of expenses at the implicit investment roll-up rate, and the conversion rate in possession reflecting the implicit interest and mortality assumptions applied in the computation of the annuity guarantee.

19. The flexibility of the Equitable RAP was one of its most significant features. By the end of 1975, the Society sold a retirement annuity contract that:

- i. Incorporated a premium guarantee, subject only to Inland Revenue limits, for the whole duration of the contract;
- ii. Guaranteed conversion rates for the whole duration to maturity in every case;
- iii. Allowed flexibility in the selection of pension age; and
- iv. Granted specified options to take alternative benefits while underscoring the Society's primary obligation to pay the specified annuity.

The premium guarantee, which allowed further contributions to be made on the same terms, and the flexibility over when benefit matured were to prove particularly significant to the Society as it sought to deal with the outcome of the *Hyman* case.

Origin of the Differential Terminal Bonus Policy

20. As the era of the retirement annuity contract was about to expire with the advent of personal pensions in 1988, Equitable decided to remove guaranteed conversion rates in possession from its new pensions business. The Society offered only a fixed expenses deduction and a guaranteed investment return from 1 July 1988 on personal pensions business and individual personal pensions. The Society also sought to remove the annuity guarantees from group pension scheme and AVC business from 1988, but faced opposition from trustees who insisted on five years' notice under the terms of the scheme contracts. However, the Society continued to operate retirement annuity and the individual pension plan business written before 1 July 1988 without attempting to withdraw or modify the implicit conversion rate guarantee, accepting additional contributions on that basis throughout the reference period.

21. Crucially the Society did not open a new bonus class that might have distinguished the pensions business sold before and after 1 July 1988 according to their respective benefits provisions, but, for marketing reasons, presented the new business as effectively a continuation of the old.

22. When the Society took that course, there had been a decision, reached by executive management in about 1983, that, if market interest rates should fall below the level required to support the guarantee for a sustained period, terminal bonus practice would be adapted to reduce the cost of the guarantee to the Society⁵. If that had not been the intention, the decision to market the new policy forms as effectively a continuation of the old, despite the different rights attaching to the different generations of policy within the same fund, would have misrepresented the interests of the respective cohorts of policyholders affected.

23. As finally manifested in the differential terminal bonus policy, this decision to recover the costs of the annuity guarantees in the event of sustained low interest rates from terminal bonus was to be the subject of the *Hyman* litigation in 1998-2000. The inquiry has found no evidence that the policy was disclosed to the Board until December 1993, a decade after it appears that it was formed and five years

⁵ See chapter 2, paragraph 51 et seq.

after the introduction of personal pensions, and this raises questions about the Board's decision to maintain a single bonus series that are considered below.

24. The policy was not disclosed to policyholders by direct communication, in any way, until 1996, in the bonus notices for the 1995 declaration. Earlier references in the Society's regulatory returns would not have disclosed the policy except to some experts reviewing the returns in detail. Failure to disclose this intention must be regarded as a serious omission in communication to policyholders of relevant information about their prospective interests from at least 1988, and arguably from the time in the early 1980s that management first took that decision.

Greater Technical Efficiency

25. Meanwhile, the Society's pensions business continued to be marketed using contract forms that were closely related in substance to, though materially changed in form from, the original RAP. The Society continued to introduce innovative changes to policy forms, and to develop new lines of business on the basic underlying model within the with-profits fund.

26. In 1987 the Society introduced the with-profits annuity, the first of a new generation of policy forms that were designed to widen the range of business, and to reduce liability reserving requirements over time. This very popular form allowed the annuitant in possession to participate in the with-profits fund. Subject to the ordinary risks associated with that fund, the with-profits annuity implicitly assumed the escalation of annuity benefits over time, but with an increasing proportion of the annuitant's interest reflected in non-guaranteed bonuses. Although it generated high initial technical reserves, the with-profits annuity became 'technically efficient' in that it reduced progressively the 'guaranteed' element of total benefits and reduced reserving requirements.

27. Another form, a with-profits bond, proved successful, but was withdrawn in 1997 because it was not 'technically efficient'. The Society also introduced forms of income draw-down policies in the early to mid-1990s with progressively reducing guarantees designed to increase their 'technical efficiency'.

28. Although these developments, and other parallel product developments, were intended to withdraw policy guarantees progressively, the Society continued to base its products on the fundamental ideas of premium flexibility, flexibility as to maturity date, and the availability of recurrent single premium terms.

29. Overall the Society developed an impressive range of products that appealed to the relatively sophisticated market sector that it targeted. The changes in the underlying assumptions within the developing forms of business would not, however, have been apparent except to financial analysts familiar with actuarial methods.

Distribution Policy

30. As noted already, the need to attract new business in the late 1960s and 1970s produced a new emphasis on competitive position. When the drive to replace the FSSU business got underway, declared bonus rates were the index of competitive performance, and the measurement of distributable surplus was the key to declaration.

31. Up to the end of 1972 the distribution policy followed by the Society provided for, and resulted in, a strong balance sheet with, as noted above, the accumulation of substantial reserves of free assets. That was, in part, the result of the tardiness of the Board in adjusting to an environment in which there had been increasing investment in equities, and, in the market conditions of the time, increasing capital appreciation. In part also it reflected a general conservatism in distribution policy that focused attention on revenue yields, and regarded capital appreciation as inherently unstable and unreliable as a basis for distribution. The Board had only reluctantly decided that up to 10% of available capital appreciation could be appropriate to supplement revenue for bonus purposes.

32. Board policy recognised the need to see that each generation of policyholders was equitably treated while maintaining the necessary, ample, reserves to provide full security for the Society's obligations. Contrary to later claims by the Society, it was explicit policy that each generation of policyholders entered the fund with the benefit of a heritage from the past and had to pass on a like heritage to its successors. The published policy position in the early 1960s was an eloquent statement of the desirability of an inherited estate, later to be rejected as repugnant to the principles applied by the Board.

33. With the departure of Ogborn in 1972, the successor team of Barry Sherlock and Roy Ranson took the initiative in developing a new, rational, approach to the appropriation of unrealised capital appreciation: the 'three-call' system⁶. In the light of current expectations, this system was inherently prudent, providing for:

- i. Support of declared bonus from capital appreciation up to the benchmark rate of the redemption yield to maturity on gilts;
- ii. Reserves sufficient to support future reversionary bonus over the period when equity yields were expected to remain below the gilt yield reference level; and
- iii. Distribution of any surplus capital appreciation to supplement bonus as the Board thought appropriate, and in particular by terminal bonus.

Thus, under this new methodology revenue returns were topped up by appropriating capital appreciation, first to support current declared reversionary bonuses, secondly to ensure that funds were available to support future reversionary bonuses, and thirdly, so far as there remained a balance of capital appreciation, to provide a new bonus element, the terminal bonus.

34. This third element, the 'third call', was inherently volatile, reflecting current property and equity market conditions. The policy adopted envisaged that smoothing of the volatility of the third call could on occasion involve allocating terminal bonus beyond immediately available capital appreciation. But that would be in a context in which the second call provided ample reserves for future reversionary bonus, and more generally a cushion against later adverse experience.

35. When the new policy framework was first disclosed to the Board, markets continued at the high level established at the end of 1972; ample surplus was anticipated at the end of the triennium; and interim and terminal rates forward were adopted on optimistic assumptions. However, in 1973 equity markets began to fall. The collapse continued into 1974. All financial institutions were affected. The Board's dilemma was clear. A conservative approach would have required lower bonuses in response to falling markets. Interim and terminal bonus rates would have had to be cut. The Society's competitive position would have been undermined at a critical point in the development of new markets for the Society's products. The view was taken that it would have been disastrous to cut bonus rates.

36. The Society maintained its bonus rates and drained its resources. The capital appreciation available at the end of 1972 was applied or lost in 1973 and 1974. The 1974 internal valuation was adjusted to take maximum advantage of the reduction in market value of the assets and the resultant increase in nominal revenue yields in valuing liabilities. By reducing liability valuations, a surplus was generated and interim bonus rates were maintained. There had been no effective recovery when the triennium ended in 1976.

37. From 1977 until 1982 the Society struggled to recover its free assets position. The three-call system was elided by an *ad hoc* bonus policy that sought to maintain declared rates while strengthening the liabilities, restoring hidden margins and increasing the investment reserves. By 1982, when assets had to be disclosed on the

⁶ See chapter 3, paragraph 14.

balance sheet at market value for the first time, the Society's accumulated reserves, representing capital appreciation, had recovered and were at a high level.

38. However, from the early 1980s the Board's bonus policy became increasingly driven by the pursuit of growth in new business. It was understood that the Society was falling behind in competitive terms, and in particular that its terminal bonus levels were not matching those of its principal competitors. A highly competitive market dictated the level of bonus allocation. The surplus published by the Society became a function of the desired level of bonus.

39. With the restoration of a position of relative strength in 1982, the three-call system came under review. Ranson, then appointed actuary, began to advise on on-going policy in terms that challenged the need for and desirability of the second call. Over the next three years, the second call was first reduced and then abandoned. Having instituted a rational approach to bonus distribution in 1973, which involved prudent reserving for future reversionary bonus and related terminal bonus to sums standing at the credit of the investment reserve, the Society abandoned the theoretical three-call system without it ever having been fully implemented in practice.

40. Over the 1980s the Society maintained competitive levels of bonus allocation by cutting back on its general reserves until, by 1987 it had over-allocated bonus so that its aggregate policy values on a realistic basis exceeded available assets. Ranson and actuarial colleagues in the Society published in *With Profits Without Mystery*⁷ a robust defence of the Society's policies and approach, putting the actuarial profession on public notice of the policies it intended to pursue. The mixed response included polite expressions of disagreement and disquiet.

41. 1990 was a disastrous year for the industry. Equitable suffered a serious loss of value on its equity holdings. The Society's response was pragmatic. It reverted to the practice of 1974 and, despite what was objectively a loss of capital value, generated an apparent surplus for allocation by maximising the interest to market value ratio used in valuing liabilities (see below). The Society also reduced declared bonus relative to total allocations, so that the proportion of the total allocation that was reflected in its liabilities valuation fell progressively. The trend in that direction had begun in the 1980s and continued throughout the 1990s.

42. Declared bonus rates were maintained broadly on a par with or slightly below general industry levels. Final bonus rates were competitive. In and after 1988 league tables were prepared on the basis of actual pay-outs at specified durations for typical products. The Society targeted the pensions position at sensitive levels, typically 15-year durations, and sought to maintain competitive position by adjusting its terminal bonus tables to produce appropriate results. In and after 1989 the Society adopted a new approach to accumulating policy values forward that automatically benefited longer durations and produced good comparative results for those durations.

43. The Society succeeded in producing good comparative returns throughout the 1990s, and presented an attractive competitive position to the market. It was successful in winning substantial new business as a result until 1998. Thereafter adverse publicity surrounding the annuity guarantee issue began to affect its competitive position.

44. The generation of surplus was critical to the Society's marketing position and success. Surplus was generated in ordinary course by investment returns achieved on premiums and contributions received, by non-profit business, by surrender terms, in particular when, from time to time, the Society operated a market value adjustment, and by actuarial techniques that reflected the Society's pragmatic approach to generating surplus required to support levels of bonus desired to maintain market position.

⁷ See chapter 4.

45. Thus the Society maintained a bonus record that enabled it to achieve consistent growth in new business premium income, net assets, and fund values over the greater part of the inquiry's reference period. It repeatedly advertised these factors as the indices of success. Whatever the other attractive features of management on which the Society relied in projecting its image, growth could not have been achieved without the support of a bonus allocation and distribution policy that produced high policy values and high policy proceeds.

Terminal bonus

46. The generation of surplus for allocation depended to a material extent on the approach to recognising accrued terminal bonus. With the exception of a specific provision of £6m in 1979, the Society never made provision in its statutory accounts, or its regulatory returns, for accrued terminal bonus. There was no obligation to set up mathematical reserves or technical provisions for accrued terminal bonus⁸.

47. Until about 1986 the investment reserve was roughly equivalent to the accrued aggregate terminal bonus. The averaging system used to adjust the 'crude' terminal bonus rate (the ratio of the investment reserve to the long-term fund) to a 'smoothed' terminal bonus rate could result in excess allocations when the reference period reflected falling returns. But the relationship was maintained in broad terms, and the investment reserve was generally equated with the terminal bonus pool.

48. In 1986 and 1987 general reserves were called on to supplement the investment reserve for terminal bonus purposes. By the end of 1987 aggregate policy values exceeded available assets at market value. For 1988 returns and bonus allocation were roughly in balance. In 1989 the allocation of terminal bonus accounted for a large proportion of the available surplus. There was a significant residual surplus and the excess of aggregate policy values over available assets was reduced. In 1990 the aggregate policy values intimated to policyholders were significantly higher than the assets available as a result of the allocations of that year. Thereafter the with-profits assets of the Society were never in excess of or equal to aggregate with-profits policy values including accrued terminal bonus⁹.

49. The Society followed the general view that terminal bonus was not guaranteed and did not have to be provided for in mathematical reserves or technical provisions. Unlike other offices, it adopted an extreme view that funds did not have to be held in any form to cover any material part of future payments of terminal bonus. In the case of the Society distributable surplus was computed without reference to terminal bonus other than that paid during the period ended with the date of the valuation. The Board was informed that terminal bonus was technically efficient because one did not have regard to what was allocated, only to what was paid. By disregarding accrued terminal bonus, the Society was able to over-allocate bonus beyond its available assets at market value, and in particular to make payments on claims that exceeded the relative available assets at the time.

Liability Valuation and Financial Adjustments

50. The inquiry has identified a number of aspects of the liability valuation and financial measures designed to support the Society's solvency position, and its ability to continue to allocate bonus at competitive levels¹⁰.

51. Between 1990 and 1996 the Society valued its annuity liabilities in its published financial statements on a basis that differentiated its future bonus rate from the valuation interest rate, using an interest rate higher than the bonus rate. The higher rate was used in its net premium valuation for regulatory purposes. The result was to reduce the liability valuation and inflate surplus. This was not consistent with best actuarial practice and was inconsistent with the Society's own

⁸ See chapter 10.

⁹ See chapter 6.

¹⁰ See chapter 7.

established practice. The practice generated surplus available for allocation by mathematical means that were inconsistent with an intuitive view of the Society's ability to pay. The allocations, over the period affected, were reflected in policy values, and in particular in claims values, throughout the 1990s.

52. From early in the 1990s the Society applied a quasi-zillmer adjustment for the procurement expenses of recurrent single premium business that eventually had an aggregate value of about £1 billion. The methodology employed was not explicit in the early 1990s, but latterly the adjustment was made in the regulatory resilience calculations where it served to reduce resilience reserves, and was therefore reflected in the surplus available for distribution. This was not consistent with sound and prudent actuarial practice. The practice generated surplus that was not properly available for distribution.

53. The Society also lagged behind generally accepted thought in adopting updated mortality factors in valuing its annuity business, deferred and in possession, thereby increasing the surplus available for allocation, by reducing the long-terms liabilities of the Society.

54. The Society included in its assets for office purposes 'aspirational' assets in the form of the new business loan, expenditure on computer systems etc, that were not realisable and should have been disregarded on a prudent basis.

55. The Society also took a number of measures to bolster its solvency position for regulatory purposes and help mask a deteriorating realistic position:

- i. issuing subordinated debt;
- ii. making extensive use of implicit profits adjustments; and
- iii. entering into a financial reinsurance agreement which supported regulatory solvency without material transfer of risk.

Each of these practices raises particular issues and these are discussed further in the context of the regulation of the Society.

Financial Weakness of the Society

56. Cumulatively these factors contributed to a position of significant over-allocation of bonus that culminated in a weak liability position that was a major contributory factor to the weakness that required a substantial reduction in policy values in July 2001¹¹. By 1987 at the latest, accrued terminal bonus exceeded available investment reserves. Over a period of years, beginning not later than 1987, rates of both reversionary and terminal bonus were set at levels that inflated maturity and other claims values to levels that were not sustainable without continuing high returns on investments, and in particular continuing capital appreciation, with the aggregate excess cost at maturity or on other claims being continually (and increasingly) passed on to succeeding generations of policyholders. That was the case notwithstanding that rates of reversionary bonus did decrease over time.

57. The excess of allocations over distributions throughout the 1990s was known to management, and was recorded in data produced regularly and circulated among executive management to inform decisions, and in particular as an aid to calculating and applying market value adjustments. More detailed analysis by the inquiry showed that the over-allocation was attributable substantially to past claims, and had crystallised accordingly. The changes in policy terms, and other technical adjustments in the 1990s were an attempt to reduce reserving requirements in respect of new business beyond the changes achieved by shifting the bonus mix progressively from guaranteed to un-guaranteed benefits. In 1997 Chris Headdon, then appointed actuary and co-author of *With Profits Without Mystery*, thought that it would take fifteen years (from an unspecified starting point) to bring allocations

¹¹ See chapters 6 to 8.

into equilibrium with assets by withholding part of current surplus from allocation to policyholders.

58. The excess of policy values over assets increased until, at 31 December 2000, the un-funded portion of aggregate policy values was about £3 billion, of which £1.8 billion had crystallised and had been lost to the fund through claims. The decision in *Hyman*, and the additional liability of £1.5 billion on top of that erosion of fund value through over-allocation and over-payment made future independence impossible. The attempted sale was inevitable thereafter. The position further deteriorated during 2001, with continuing over-payment and falling equity values.

59. A key feature of the Society's bonus system, introduced in 1989, was the uniform smoothed investment return allocated to accumulated policy values. While the actual split between the guaranteed return, reversionary and terminal bonus might vary between policy structures, the same total return was allocated to policies regardless of duration. This was in contrast to the approach of other companies, which operated a more flexible bonus system where terminal bonus could be varied according to policies' duration in-force. Common practice allowed for inter-generational smoothing and so avoided locking in payout patterns. By effectively giving up this flexibility, the Society significantly reduced its ability to smooth payouts and thereby manage the aggregate of such payouts within available resources.

60. The consequence of the Society's approach to bonus, combined with sustained over-allocation, was a complex pattern of differentials between policy values and asset shares that depended on policy duration. There was no effective means by which the Society could correct the overall differential, which was progressively crystallised into a pattern of payout ratios, without a drastic revision of the policy values already intimated to policyholders. Such action was not considered until the second quarter of 2001. The Society sought to claw back past over-allocations from in-force business in 2001, but until July of that year the basic pattern of payout ratios in excess of 100% of asset share continued.

61. While it was still possible, using the Society's bonus system, to bring aggregate payouts in line with asset shares, this would have involved paying some policies less than their asset share. It is evident that for contractual claims the Society paid out on policy value, the payout ratio being in excess of 100% of asset share for the period from at least 1989 to July 2001. While it did apply varying financial adjusters to non-contractual claims from time to time, such application was discretionary, and crude, which reduced the effectiveness of the mechanism to claw back value. While the Society made attempts to smooth in-force business, it did not do so on claims generally, thereby in effect crystallising a fund deficit of an estimated £1.8 billion by 31 December 2000. Given this situation, it would appear that not only did the Society fail to manage appropriately and address inter-generational transfers, but it greatly encumbered new and in-force business.

62. Various representations have sought to suggest that the pattern of policy values observed by the inquiry was consistent with the Society's smoothing policy. Apart from the absence of a consistently expressed and coherently followed smoothing policy (of which more below), it is hard to reconcile what the inquiry has found with any credible approach to smoothing. Smoothing is generally taken to imply that payout ratios should average 100% of a projected norm over time, with aggregate policy values and payouts running below the level of available assets during market peaks, and above the level during downturns. A rigorous and prudent adherence to a clearly defined set of smoothing parameters would appear to be all the more essential in a fund that is being operated on the basis of a policy of full distribution and no estate. The Society's pattern of 'smoothing across the peaks' (to borrow Headdon's phrase) did not represent, and could not have represented, a credible approach to smoothing for a mutual espousing the principles the Society did.

63. As a result of the practices adopted in the generation of surplus for allocation, in the allocation of total bonuses, and in the excess payout on claims, the Society was 'overdrawn' on the internal office valuation to the extent of £4.4 billion by about mid-July 2001. The cut in policy values in July 2001 reflected in part the loss of investment value in the stock market collapse in that and the preceding year, and in part the cumulative effect of over-allocation, and in particular the resulting over-payment on maturities and other claims from 1987 onwards.

Table 19.1: Office valuation position from 31 December 2000 to 31 August 2001

With-profits fund	31/12/00 30/06/01 31/07/01 31/08/01			
	<u>£m</u>	<u>£m</u>	<u>£m</u>	<u>£m</u>
Net assets	25,843	22,848	22,500	21,965
With-profits liabilities at full value	21,467	19,670	19,303	18,893
Guaranteed annuity provision	1,500	1,500	1,257	1,257
Face value of guarantees	22,967	21,170	20,560	20,150
Accrued terminal bonus	5,933	6,055	1,340	1,330
Aggregate Policy Values	28,900	27,225	21,900	21,480
(Unfunded) Funded Policy Value Position	(3,057)	(4,377)	600	485
Aggregate policy values as a % of net assets	112%	119%	97%	98%

64. The year-end relationship between aggregate policy values and underlying assets (net assets), as depicted by the Society's own records, reflected a ratio of 105% in 1989 and thereafter peaking at 128% and 120% in 1990 and 1994 respectively. From these peaks the Society was able to smooth down the position on in-force business, to 102% in 1993 and 103% in 1999. The position thereafter deteriorated again in 2000 to 112%, as shown in the table above, which was largely attributable to market performance and the need to accrue for the annuity guarantees. Due to a combination of continued poor market performance and excess payouts, the position further deteriorated to 119% before policy values were cut in July 2001, bringing aggregate policy values and underlying assets more into line and for the first time during this period below 100%. However, despite the Society's apparent attempts to correct the imbalance, particularly after 1997, it is important to note that the ratio never fell below 100% prior to the 2001 adjustment. The fundamental impact of this was that claims continued to be paid out well in excess of asset share, thereby exacerbating the Society's financial weakness and placing a greater strain on new and in-force business.

65. In addition to the broad valuation issues that arose as part of the background to the July reduction, principally accrued final bonus, mortality, the GAR issue, and aspirational assets, there were unresolved issues relating to policyholders' and former policyholders' claims for damages, the status of the subordinated loan, the appropriateness of future profits implicit items adjustments, the financial reinsurance of the GAR liabilities, and the identification of on-going contractual guarantees.

Representations on the Inquiry's Financial Analysis

66. I note that I have received various representations concerning the inquiry's analysis of the financial position of the Society. Ranson in particular has contested my comments in this regard. However, the basis of my views is set out in chapter 6 and reflects the actuarial and accounting advice I have received. Ranson has also commented that I have ignored the intra-year position, that Ernst & Young's report for the sale process identified significant accrued profits in in-force business beyond

those taken into account, and that I have ignored embedded value and goodwill. I have not taken account of these factors, but consider it immaterial. A consistent pattern has emerged at year-end over a long period of time, and in any event, Ranson's general comment about intra-year positions without specification of any relevant difference is unhelpful and without material significance. On the basis of Ernst & Young's report the Society would have been saleable, but it was not sold. Embedded value and goodwill were not realisable while the Society was a going concern mutual running a mixed business.

67. I have also received representations on behalf of some non-executives to the effect that they do not recognise my analysis of the financial position, that on the advice they received and on external assessments the Society was subject to no financial dangers or risks that were not taken into account until the *Hyman* decision, that they did understand that terminal bonus crystallised on claims, and that had they known of a position as I have described, they would have queried it. They say that they understood that bonus levels had been set at prudent levels in the light of the Society's smoothing position and the general economic climate. These observations do not alter these findings. Discussion of the developing position is set out in chapter 6, and I discuss smoothing further below, and since the non-executives in question did not attend for interview, what it is said on their behalf that they understood is not material to which I can attach significance.

68. Nor are the findings altered by the objections from Thomas and Bowley, two of the executive directors, that it is difficult to see how over-distribution could occur in the Society's case, given the policy of full and fair distribution, given that the returns achieved on the invested assets were generally comparable with their competitors, and given the limited number of top rankings achieved by the Society. The reasoning behind these representations is surprising, given the individuals' background and experience, but not such as to disturb the conclusion set out.

69. As for the claim frequently made by the Society, and cited in a number of representations, that it had a policy of smoothing bonus distribution, there was no adequate statement of that smoothing policy or its parameters, in terms of cycle or maximum deviation from any norm, against which decisions on distribution might have been reviewed. It has been represented to me that the Board was given regular indications of where the Society was at any time in the smoothing cycle. I have referred in the report to the particular instances I have identified, including the one on 15 November 1995 commented on by solicitors in their representations on maxwellisation. The specific instances do not persuade me that there was at any time an adequate statement of the smoothing policy. If their clients have other information it has not been disclosed to me.

Policyholders' Reasonable Expectations

70. There are two aspects of PRE¹² that have to be considered, relation to the annuity guarantees, and in relation to final bonus. The first is more limited, but is more conveniently dealt with first.

71. The Society's publications and communications with policyholders until 1996 (in relation to the 1995 distribution) gave rise to the reasonable expectation that total policy proceeds at maturity, or other point of claim (subject to MVA at certain times), made up of the accumulation of premiums, GIR, reversionary bonuses and a final bonus, would be computed irrespective of the form in which annuity benefits were claimed. This was seen early in the historical treatment of RAPs, in the provisions of the contract, and in the explicit provision in the commutation tables for the reversal of the final annuity bonus or adjustment when the cash commutation option was exercised. That provision was required only because it was assumed that otherwise the fund equivalent of the annuity would include the

¹² For a discussion of the origin and interpretation of PRE, see chapter 13. Chapter 14 considers PRE in terms of the Society's own practices and communications with its policyholders.

addition. Illustrations, bonus notices, and correspondence all pointed in the same direction until 1995.

72. Attempts were made to change expectations in 1996 and later years. These were ill-conceived, poorly expressed, and confusing. The intimations to policyholders were generally uncommunicative. They did not fit with the contractual provisions to which they were intended to relate. They could not seriously be considered as instructing new expectations, even if that were theoretically possible. (There is an issue whether an office can alter PREs retrospectively: if the PREs have been established, prima facie unilateral assertion of a different and inconsistent position is a breach which, if material, would require regulatory intervention.)

73. In 1998 and 1999 the attempt to amend expectations was continued. There was inadequate communication of the Board's intentions even then. However, whatever the resolution of the position in the final two years, it was fundamentally inconsistent with established PREs for the Society to attempt to implement the differential final bonus policy in respect of contributions paid up to and including the publication of the bonus notice in 1999 for the 1998 declaration. The Society should have reserved for annuity guarantees in full up to and including 1997, even if beyond that date there was scope for change.

74. There is a separate issue whether PREs were generated in respect of new contributions on pre-July 1988 (i.e. GAR) policies after the Society's position was made clear in public in 1998. No policyholder making a contribution after August 1998 could have been in doubt about the Society's position in the Hyman litigation. Additional contributions in that period could not have been made in the expectation that the differential terminal bonus policy would not be applied if the Society were entitled to act in accordance with its stated policy.

PRE and Final Bonus

75. On the more general question relating to final bonus, the Society's position on PRE was that, because accrued terminal bonus was not guaranteed, it was payable wholly at the discretion of the Society, and did not require to be reserved for or recognised in any other way prior to payment. In and after 1989, when the Society adopted a new approach to accumulating policy values, the failure to recognise accruing final bonus in its entirety was untenable, having regard to the terms of the statute and to the Society's publications and communications with policyholders.

76. On no view of the meaning of the expression 'policyholders' reasonable expectations' could it properly be asserted that it related exclusively to guaranteed benefits. The expressions 'contractual', 'guaranteed' and 'consolidated' were used as synonyms by the Society and must be construed in that sense in the bonus literature distributed to members.

77. Policyholders would have known at all times that the amount of accrued terminal bonus intimated in bonus notices was not due as a matter of contractual right. But that did not and could not close the issue. Having regard to the origins of the expression, and the circumstances of its incorporation into the legislation, PRE had a wide compass and, in particular, covered future non-contractual financial benefits. Protecting policyholders' interests in future bonuses (as then understood) was a central feature of discussions of PRE in the early 1970s.

78. Subject to the terms of the communications, policyholders presented with the Society's policy value statements from 1989 had a reasonable expectation that a final bonus would be incorporated into the policy proceeds at maturity, subject to the conditions of the market at the time. Indeed policyholders (and the Society's Board and the profession through *With Profits Without Mystery*) were told in the 1990s that the bonus mix was irrelevant: only the final proceeds mattered to them. That representation was consistent only with a *bona fide* intention to pay a final bonus according to current market conditions and the stage in the Society's current smoothing cycle, if there were a relevant smoothing policy. The sole qualification in the documents was that the level of final bonus was dependent on market

conditions at the contractual date of claim. The level of expectations ought to have been conditioned by expectations about the performance of equity and property markets in particular.

79. The Society predicted future reversionary bonus as an element in the calculation of surplus on its preferred actuarial methodology. The Board could not have asserted that there was no expectation of continuing surplus. The claim for a future profits item had implicit in it the assertion that current values of in force business implied valuation margins that allowed for the emergence of future profits. The quasi-zillmer adjustment, subordinated loan and financial reinsurance each required the availability of future profits. The continued investment of new money in equities and properties would have been imprudent without the expectation of future growth in yield and market value.

80. The failure to cover future terminal bonus by the retention of funds, given the expectations generated by representations, and by the Society's sustained practice of paying such bonuses on maturities and other claims, contributed significantly to its ultimate weakness.

81. These general factors provide the background to an assessment of the impact of the *Hyman* decision, and the need to make provision for annuity guarantee liabilities. The necessary provision was, in absolute terms, a material sum. But its impact would have been less if the Society's capital base had not already been eroded by over-allocation and in particular by over-payment on claims. On previous experience the shock would have been sustainable.

82. The Society was under-funded to the extent of £4½ billion in the summer of 2001. It had contributed to that position by over-allocation of bonus, reflected in over-payment on claims. Surplus had been generated by an extreme use of actuarial techniques, and applied to support bonuses of all kinds. The question arises as to who knew and how the decisions were taken.

The Board

83. The composition of the Board changed over the period I have investigated. Some directors have died. Some have been and remain infirm. Some have agreed to interview, and have co-operated to a greater or lesser extent, largely depending on whether they have been involved in litigation brought against them by the Society. Some have refused to be interviewed. Some have asked that their identities and terms of office be disclosed in the report. Some have asked that their membership of the Board should not be disclosed. As more fully set out in the foreword, I have taken the view that I should deal with the Board as a continuing unit. Since it is not my task to adjudicate on individual responsibility for events that have taken place, and since I have relied on hindsight rather than attempt to distinguish what was known at any given time from what emerged subsequently, that has appeared to me to be the most appropriate course. I note that some directors have criticised this approach, which one executive has described as "curious" and "inherently unfair", but I remain persuaded that it is the only one that could be adopted by the inquiry in the circumstances.

84. Formally under the articles of association the Board resolved on bonus levels on a report from 'the actuary', who was in effect the managing director under the articles. The Board received extensive reports from the actuary on the Society's financial position, and on the levels of bonus they might allocate and declare. However, on balance it appears to me that the Board was never fully advised of the financial implications of the decisions that were said to be open to them, and, in particular, of the impact of claims on the resources covering with-profits business.

85. The executive over most of the reference period provided financial information in series of reports that did not bring together all relevant information at any one time, such as would have been provided in what came to be called an annual

financial condition report. In particular, a comprehensive report, however designated, would have presented an assessment of future scenarios that put in issue the resilience of the Society in adverse financial circumstances. As a result of practice, the Board had fragmented information and, even if directors had all the relevant pieces of the jigsaw, they were most unlikely to have been able to piece them together and form a picture of the totality.

86. While the Board established committees to study in detail matters such as investment, remuneration, and nominations, at no time until 1994 did it establish any committee that could have had within its remit the monitoring of product risk, or liability valuation and the risks associated with that exercise and the associated exercise of bonus allocation and distribution¹³. In 1994 an audit committee was set up. Of its nature an audit committee could have captured the area of liability valuation. It did not do so until initiatives late in 1997 began to have effect in 1998, by which time the Society's problems were largely beyond resolution.

87. Internal management committees dealing with risk assessment concentrated on areas that left product and liability risks substantially untouched. They dealt with systems monitoring, internal controls, fraud by staff, accounting systems, and similar topics. There is no doubt that the Society's management systems were well-developed, and benefited from the attention of the review units. But the level of attention given to these matters serves to underline the absence of any equivalent body to scrutinise the actuarial functions of the Society (which were located at Aylesbury, away from the head office).

88. There was no effective monitoring of risks associated with product design and development. Development involved considerable imaginative effort that was centred in the product investigation team (PIT). But no one 'audited' the PIT, and there was no effective control of the reserving requirements generated by new policy forms outside of the actuarial team. So far as the Board was concerned, control over policy drafting and development was delegated to the actuary with occasional reference to the president. Generally, the Board was less than well-informed of the Society's realistic financial position, and by its resolutions on bonus brought the Society to the position of weakness in which it found itself in 2000 and 2001 without full knowledge and understanding of the developing position.

Role of the Non-Executives

89. None of the non-executive members of the Board had relevant skills or experience of actuarial principles or methodologies over most of the reference period. They were generally experienced in the financial services industry, but specialists, where they had specialist knowledge, in general finance, in investment and banking rather than life assurance. They could not be expected to make independent judgements without specific guidance from the actuaries on and advising the Board. There were executive directors with relevant actuarial qualifications, but little or no relevant experience, and they were in any event inhibited by the terms of professional guidance (which prohibited qualified actuaries who were directors from doing anything to undermine the authority of the appointed actuary).

90. I accept the evidence of those non-executives who were prepared to be interviewed by the inquiry that they did not know of the extent of over-allocation as brought out in the office valuation of liabilities. If that is so, they did not understand the risks to which the Society was exposed. I can express no view on the position of those who declined to attend for interview. The reasons for the relevant directors' lack of knowledge were that the non-executive directors were:

- i. Ill-equipped to manage a life office by training or experience;
- ii. Totally dependent on actuarial advice;

¹³ See chapter 9.

- iii. Ill-prepared to take necessary decisions in any event because of the fragmented approach adopted to instructing them; and
- iv. Incompetent to assess the advice objectively and challenge the actuaries even if they had questions about the material supplied.

91. The non-executive directors generally had a poor understanding of the Society's developing financial position. They had delegated actuarial management to the professionals. Delegation is, in principle, necessary in the management of any complex commercial organisation. In an extreme case, total abrogation of all responsibility for actuarial management of a life office could not be. Whether the directors from time to time did what was required for proper performance of their duties is not for me to say. I have not sought to test their performance against any body of evidence of what others in their position would have done in the circumstances, or otherwise collected evidence or sought to adjudicate on allegations of breach of duty that others have made or might have made. An inquisitorial process could not attempt to supersede the ordinary courts in the exercise of their jurisdiction. My function has been to look at what happened, and how it contributed or may have contributed to the position at the reference date, and to draw any lessons for the future.

92. In the course of maxwellisation representations, non-executive directors and their legal representatives have repeatedly stated that criticisms that relate to matters of an actuarial nature that were not known, and could not be known on the information supplied, to a generalist non-executive director, or otherwise could not reasonably have caused them to ascertain or pursue the concerns identified, set standards that are unrealistic and would be impossible to achieve for an individual without actuarial experience¹⁴. It should be clear that I have not sought to set standards of conduct for any past period. I do have an interest in using what happened as the basis of comment about the future. But it has to be said that there is and will continue to be a material difference between the ability to carry out work, and in particular the technical calculations, that an actuary is qualified to perform and understanding the results of that work.

93. In the same representations it has been repeatedly stated that criticism of non-executive directors related to failure to oversee the actuarial functions of the Society are misconceived, because they were entitled to rely and did rely on the actuaries on the Board and the actuarial team. And, it is said, they relied on the auditors, regulators and in particular GAD. At no time, it is said, did the auditors or regulators alert the Board to the kinds of comments made by me. It has been said that it is little short of absurd to expect a generalist non-executive director, without experience in actuarial issues, to have ascertained the matters that form the basis of my comments when external experts failed to do so.

94. Whether or not reliance on external safeguards was appropriate in contemporary circumstances over the period I have investigated is not a matter for me to comment on. Again, however, if the position should be as represented to me, it has significance for the future governance of life offices. Whether or not the representations reflect views common in the industry, one would wish to ensure that the future conduct of life business reflected acceptance by non-executive and other directors of personal responsibility for the direction of the actuarial functions of the office. The long-term liabilities of life offices do tend to dominate one half of the balance sheet. If it were indeed absurd to expect an understanding of the actuarial issues that arise in their valuation by 'generalist non-executive directors', that is a matter of some importance for the exercise by regulatory authorities of their function of approval of nominees for appointment to life offices' boards.

¹⁴ The comments reflect specifically the observations of Allen & Overy with which most of those non-executives who have made representations expressly agreed. Many of the representations commented on in this section were made by Allen & Overy, but I have not sought to attribute them in every case.

Bonus Allocation

95. Against the background of these general comments, I turn to specific issues. It is appropriate to comment in the first place on bonus policy. In terms of the Society's articles of association, formal responsibility for distribution lay with the Board at all times. Having adopted a rational approach to bonus distribution policy in 1973 that involved prudent reserving for future reversionary bonuses and related terminal bonus to sums standing at credit of investment reserve, the Board as constituted over the material period began progressively to reduce the reserves held for future reversionary bonuses from 1983 until that aspect of the previous reserving policy was abandoned entirely in 1985. In and after 1983 the amount allotted as terminal, later final, bonus was progressively increased. (It has been represented that if such policies existed they were never made known to members of the Board over the last few years before the *Hyman* litigation. I have no information on the extent of the information given to new directors in the course of induction. But the issue is material to the FSA's proposals for published PPFMs and other statements of practice discussed in the next chapter.)

96. The Board was advised repeatedly, and acted on the basis of the advice, that future terminal bonus could be withdrawn instantly and did not require to be provided for or otherwise recognised in order to run the business in a prudent and sustainable manner. Insufficient attention was paid to the aggregate policy value position of the Society (figures for which were routinely calculated as part of the Society's systems) as compared with the aggregate market value of the assets.

97. This statement has been challenged on behalf of certain of the non-executive directors on the grounds firstly that GAD expressed a view on 16 January 1998 that showed no concern about the excess of policy values over available assets, and secondly that correspondence dated 3 and 8 November 1995 between Headdon and Ernst & Young supported the Society's approach to full distribution. However, these specific events do not disturb the basis of views formed by the examination of board papers and minutes over a long period of time. Bowley and Thomas have commented that the pattern of allocation was a natural consequence of movement in the securities market over time. I refer the reader to the detailed discussion of the development of these policies in Part II to this report. The same individuals have commented that the criticism implicit in the observations fails to acknowledge actual experience within the fund. I have dealt with the realities in chapter 6. I have found no basis for altering the comments above on the basis of their representations.

Excess of Policy Values over Assets

98. As noted above, accrued terminal bonus exceeded available investment reserves by 1987 at the latest. Over a period of years, beginning not later than 1987, rates of both reversionary and terminal bonus were set at levels that inflated maturity and other claims values to levels that were not sustainable without continuing high returns on investments, with the aggregate cost at maturity or on other claims being continually (and increasingly) passed on to succeeding generations of policyholders. That was the case notwithstanding that rates of reversionary bonus did decrease over time. The excess of policy values over assets increased until, at 31 December 2000, the un-funded portion of aggregate policy values was £3 billion, of which £1.8 billion had been crystallised through claims. The position deteriorated during 2001.

99. By August 1997 actuarial executives of the Society had estimated that as a result of historical over-distribution the aggregate deficit on in-force business at 31 December 1996 was £1,725 million of which over £900 million had crystallised on claims. On the inquiry's calculations that position had deteriorated significantly by 31 December 1997. By September 1998 the executives had estimated the potential cost of the annuity guarantee issue to be £1.5 billion. In view of the estimates made internally, albeit related to different types of adjustment, it would have been clear to the Board, if they had sought and obtained information about the aggregate position on the with-profits fund, that correcting the over-distribution would take many years

on the basis of current bonus policy, even if the Society were able to maintain its stance on the annuity guarantees.

100. I accept that, on the evidence available to me, the Board as a whole was unaware of the estimates of over-allocation of bonus, and in particular of the over-payment that resulted on maturities and other claims. There were no adequate systems at Board level for assessment and reporting of the financial position of the with-profits fund that would have disclosed such matters on routine reporting, and I have found no evidence of specific enquiry or challenge that would have brought the information to light. I note that there have been representations to the effect that it was the appointed actuary's responsibility to ensure that reports were accurate and complete, and that non-executive directors have no responsibility for the actuarial management of the Society. It is not for me to comment on the extent of the directors' duties at the time, which may be a matter for the court in the case that has been sent for trial, but the representations have a material bearing on what should be required of directors in future.

101. The Board had formal and actual responsibility for decisions on bonus distribution and, by its decisions, caused the material over-distribution that weakened the Society's financial position and contributed significantly to the ultimate reduction in policy values in July 2001.

Liability Valuation

102. Surplus apparently available for distribution was supported by actuarial techniques that reduced liability values:

- i. Quasi-zillmerisation in respect of recurrent single premium business;
- ii. Between 1990 and 1996, different interest rates were used for projecting gross bonus rates and for discounting liabilities, with the result that the liabilities in respect of recurrent single premium business were valued at less than face value.
- iii. Delayed up-dating of mortality assumptions¹⁵.

Again it has been represented to me on behalf of some non-executives that these were matters for the actuary, and that ensuring that actuarial techniques were appropriate were functions of the appointed actuary, the auditors and the regulators, including GAD. More surprisingly, similar representations have been made by Thomas and Bowley, who were both qualified actuaries, but whose executive functions, they say, did not involve actuarial expertise. They claimed that they took comfort from the skills of the Society's actuarial team, the auditors and the regulators including GAD.

103. The Board instituted no means of oversight over the valuation methods employed by its actuarial staff until the late 1990s. The development of risk management functions and an audit committee did not provide even formally for effective oversight in this area until 1998. The Board had no access to, or means of forming independent views of, the appropriateness of the methodologies employed.

104. The Board relied on reports made directly to them by the Society's senior actuarial staff, and in particular the appointed actuary, without instituting and maintaining any committee system to consider in detail and report on actuarial management (which was in marked contrast to the Board's approach to investment management, in relation to which there was active committee involvement). Headdon has pointed to the monthly reports on solvency and sensitivity and has commented

¹⁵ Ranson and Headdon have both criticised this comment as insufficiently specific, and Headdon has provided the inquiry with further information about the mortality assumptions applied. What was communicated was the gist of possible criticisms, and it was made clear that the materials relied on were available for them to consider before responding to the maxwellisation process. Neither Headdon nor Ranson took the opportunity provided by me to read the material on which the comment was and is based. See chapters 6, 16 and 17.

that the Board was kept abreast of the liability position. I accept that the Board received monthly reports as he says, but the presentation of this data to the Board without a process of pre-digestion was unsatisfactory, not least because of the volume of business transacted, the brevity of the board meetings, and the lack of qualified non-executives capable of assimilating and challenging the material provided. The information supplied did not extend to disclosure of the Society's realistic position.

105. The Board accepted advice that the duty of the appointed actuary to the regulator qualified his duty to the Board, with the effect that parts of the regulatory returns (specifically schedules 4 and 6) received no scrutiny from the directors, so that neither in relation to its domestic and Companies Act accounting nor in relation to its regulatory returns did the Board have means of monitoring the valuation of liabilities. I acknowledge that communications between the appointed actuary and the Board improved when Headdon took over as appointed actuary, but that does not alter the thrust of this comment. The liability valuations entered into the Society's financial statements, and those statements were the Board's. That was not affected by the appointed actuary's separate obligations. The Board's responsibilities to policyholders remained comprehensive.

106. I do not propose to rehearse here the extensive representations I have received from Allen & Overy about risk management generally. I have discussed the position in chapter 9. However, I note that they have indicated that, in respect of liability valuation, their clients relied on the appointed actuary, the in-house team of actuaries, the auditors and regulators, including GAD. As in other contexts the factual position of their particular clients as individuals is unknown to me because of their refusal to co-operate with the inquiry.

107. In terms of the Society's articles all delegations of authority were subject to variation or recall. The Board had no system of review of the performance by its officers of the critical function of liability valuation. (In making this criticism, I acknowledge that the actuary's function under article 65(1) was an ascribed function of the actuary, not a delegation by the Board. However, article 65 referred only to the report required in the context of distribution: it did not apply to the regular valuation of liabilities required throughout the year.)

Oversight of Actuarial Function

108. There was a general lack of robust and effective scrutiny of management systems in the actuarial area. Among the weaknesses was a failure until 2000 to require the production of annual financial condition reports or equivalent reports that brought together different sources of information about the current position of the business and assessed business risks going forward. Financial condition reports, so-called, were a recent innovation in 1997, but the precise form of reporting is subordinate to the general problem associated with piece-meal reporting without a comprehensive analysis supported by projections of likely future experience.

109. So far as the actuarially qualified members of the Board are concerned, there was no acceptable evidence that they used their actuarial skills to support the Board by requiring adequate risk management systems to be put in place in relation to liabilities. Through their solicitors, Thomas and Bowley have commented that, though qualified actuaries, they did not get involved in the detailed actuarial techniques and should not have been expected to. They would have questioned the appointed actuary and actuary where necessary, and would have been satisfied with their responses received, otherwise they would have questioned them further. The wholly unsatisfactory nature of the Board minutes makes it impossible generally to identify discussion or who contributed to it. I have not been able to identify any occasion when either individual acted as the comment suggests, and no example has been brought to my notice.

Product Design

110. There was no effective system for review of product design by the Board, with the result that, inter alia:

- i. Product design was changed through the late 1980s and 1990s so as progressively to reduce guaranteed benefits within new products. This increased the shift within the bonus mix towards un-guaranteed benefits and aggravated the problems resulting from the reserving policy referred to above.
- ii. The Board did not identify the guaranteed annuity problem at critical times in the development of the business, and in particular on the introduction of with-profits annuities in 1987, personal pensions in 1988, managed annuities in 1990 and managed pensions in 1994, the removal of the guaranteed investment return from new policies from 1996 and the removal of reversionary bonuses from 1998.

Allen & Overy have contended that product design was clearly an executive function that a generalist non-executive director would not have been competent to review. Whether or not the firm's clients and other non-executive directors had a duty to review product design is not a matter for me. But I would again observe that liabilities, which are what the products generated, were fundamental to the financial health of the Society. If non-executive directors are not competent to review product liabilities, that should be a matter of concern. It may be something that requires to be addressed by FSA in the context of approval of proposed nominees for Board appointments.

111. The absence of effective scrutiny of new products contributed to a more general failure to put in place adequate arrangements for assessing and managing liability risks. The lack of effective arrangements for monitoring product risk and associated valuation matters resulted in the Board having inadequate information about business risk generally and about problems associated with the annuity guarantees in particular.

Differential Terminal Bonus Policy

112. The inquiry has not uncovered any evidence that the Board was aware that the intention to recover the cost of annuity guarantees from terminal bonus in the event of a sustained low interest rate environment was formed late in 1982 or early in 1983 following on the temporary fall in interest rates in the autumn of 1982. There has been no evidence that management's views on such a policy were communicated to the Board at any time prior to December 1993.

113. The decision to maintain identical premium bases and a single bonus series for retirement annuity and personal pensions business in 1988 was predicated on the view that benefit rights were equal, a view that must have been based on the existence of a management policy that came ultimately to be expressed in the differential terminal bonus policy applicable in the event that the annuity guarantees came into the money. I accept Allen & Overy's comment that the Board was not committed to maintaining the practice of common rates, but the business was sold on the basis that the old and new forms were equivalent. I also note the suggestion that Headdon's paper proposing in December 1998 to allot lower or no bonuses to GAR policyholders was an indication of the Board's understanding that there was an ability to distinguish the series if they thought that fair. The events of late 1998 are not, in my view, a fair indication of attitudes over time. By then steps were contemplated that were not characteristic of policy generally.

114. On the hypothesis that the Board was not aware of the policy in 1988, the decision taken at that time to maintain a single series would have been taken without sufficient consideration of and without taking advice on the differences in policy terms between the old and new products. There is no evidence that the Board addressed these matters. There was extensive discussion of the new policy forms introduced in 1988, in the light of the LAUTRO requirements introduced at that

time, involving the Society's solicitors, but no indication of comparative analysis of the benefits provisions of the older and newer forms.

115. As commented above, this particular matter of the treatment of annuity guarantee liabilities reflected the general lack of a system of control over product design over the period studied. The steps taken by the Board to establish better controls did not encompass the work of the actuarial department until the issue of the annuity guarantees had already emerged.

The Executives

Roy Ranson

116. During the period 1982 to 1992, Roy Ranson was the appointed actuary, with Barry Sherlock as chief executive, and from 1992 to 1997 he was the chief executive and appointed actuary. Throughout this fifteen-year period Ranson was the executive mainly responsible for communicating technical and professional actuarial advice to the Board. It was Ranson who provided reports to the Board, initially supported by Sherlock and latterly supported by Chris Headdon and on occasion Alan Nash, and it was through his reports that the Board had access to information regarding:

- i. the financial position of the Society;
- ii. the financial risks involved in the decisions the Board was invited to take;
- iii. the long-term financial implications for the Society of the valuation and solvency calculations and the distribution practices followed; and
- iv. the long-term financial risks inherent in the contracts written by the Society.

In the course of maxwellisation, Ranson has maintained that the comments in this section present a misleading picture of his position in the hierarchy. My views are based on an assessment of the total information available to me, including my assessment of Ranson and Sherlock respectively as witnesses.

117. It may also be claimed, in mitigation of the non-executives, that the Board was dominated by Ranson. If so, that is a matter for other proceedings. I was denied the evidence of some of those directors I invited for interview, and it would be inappropriate to express a view on a matter of this kind on the basis of limited evidence. At interview, I found Ranson to be highly intelligent and articulate, but manipulative. I was not persuaded that his memory was as inconsistent as he asserted, nor that he had put the Society's affairs so completely behind him at his retirement that he could not comment on some of the matters that were put to him. Without the benefit of an adversarial process in which his evidence could be tested by cross-examination I cannot form any concluded view on the reliability of his evidence relating to his relationship with the Board. But I note his own assessment of his approach, in discussion with regulators, as 'autocratic'. That coincides with other information available to me.

118. Substantial amounts of technical and financial information were provided to the Board. This was done primarily by means of periodical reports that were individually less than comprehensive. These failed fully to present the overall financial position of the Society, and in particular the risks inherent in the policies that were pursued in relation to bonus allocation, as would have been brought out, for example, by an annual financial condition report, or equivalent overall report, supported by stochastic or other statistical analysis that took account of the possible ranges of experience over a period of time that reflected the projected duration of the Society's in force business. The typical presentation of deterministic projections based on a 3-year rolling programme was inadequate for these purposes. Further the realistic position of the Society and the other factors identified were not reported on a regular basis.

119. In his maxwellisation representations, Ranson has observed that reporting on many of the financial matters identified, which would have featured in the projections of a different type of office, were of less relevance to the Society's future performance because of the predominance of recurrent single premium business. He has contended that there was no model that would have been suitable. And he has contended that the need for a financial condition report was a matter on which actuaries entertained differing views. I have not sought to form or express a view whether Ranson was in breach of duty in failing to provide a financial condition report. That is a matter for the courts and for his professional institute. In other respects, in my view, the Society's uniqueness lay in the approach adopted by its management, not in the essential characteristics of its business.

120. In advising on bonus mix, and on the ability of the Society to manage payments on maturities and other claims, Ranson persistently emphasised that there was no need to reserve for accrued terminal bonus in regulatory returns, or to provide for emerging liabilities in the Companies Act financial statements. That was technically correct, but the prudence of recognising in financial statements the accrued value of terminal bonus intimated to policyholders, in and after 1989 in particular, was not the subject of advice. Typically that would have been done by holding investment reserve or fund for future appropriation balances against all or some specified part of the accrued terminal bonus. In adopting the approach he did, Ranson advised the Board to fix levels of terminal bonus that were reflected in current claims values and which progressively built up deficiencies of available assets in relation to advertised policy values, as well as inflating the policy values of in-force business beyond the Society's available assets.

121. Ranson did not advise the Board of the risk that persistent practice associated with published statements of practice would develop policyholders' reasonable expectations (PRE) that existing patterns of payment would continue to characterise the Society's bonus practices in the future. In particular the advice that future terminal bonus payments were not guaranteed (that is not contractually due) diverted attention from the risks associated with the generation of non-contractual expectations of future terminal bonus payments.

122. In valuing the Society's liabilities internally, Ranson adopted between 1990 and 1997 the change of practice already mentioned in relation to the valuation discount rates relative to bonus projections that generated an apparently distributable surplus that was not truly reflective of the Society's financial position, and in particular its capacity to allocate reversionary and terminal bonuses. That was especially the case in 1990, 1991 and 1994. The use of an associated higher valuation discount rate in the Companies Act accounts and regulatory returns inflated surplus and profit in those contexts.

123. With particular reference to the regulatory returns, on the evidence available to me, Ranson:

- i. from some point in the 1990s adopted a practice of using a quasi-zillmer adjustment in circumstances in which zillmerising was inappropriate, having regard to the fact that the Society's business was predominantly recurrent single premium; and
- ii. used future profits implicit items inappropriately and without adequate analysis of the future profits available on in-force business.

Other mechanisms that depended on the same future profits included the subordinated loan obtained to support solvency in 1997.

124. In relation to the Society's position overall, it was progressively weakened from 1983 (the 1982 valuation) by the reduction in the second call (non-technical) reserving for future reversionary bonus. Between 1983 and 1985 the weakening and final abandonment of the second call resulted in:

- iii. the inflation of the third call available for the terminal bonus; and

- iv. the appropriation of progressively higher proportions of the third call values in terminal bonus allocations.

Together with the adoption of the marketing adjustment in 1986-87 to be applied at Ranson's discretion, for which there was no warrant in the Society's articles, these steps resulted in the Society's total bonus allocations including terminal bonus exceeding available assets at market value at the latest by 1987, from which deficiency the Society never thereafter recovered. I note that Ranson has denied that the marketing adjustment was something to be applied at his discretion, and that the adjustment was implicit within the rates determined by the Board. However, my conclusion is based on his own reports as approved by the Board¹⁶.

125. Ranson did not advise the Board on the requirements of a systematic policy for smoothing of returns to policyholders that provided criteria for the smoothing cycle and permissible deviations from a specified norm against which to measure total bonus allocations. No such policy was adopted and applied by the Board. Ranson has denied this and referred me to his paper dated 15 November 1995. I have dealt with that paper in context. However, selective presentation of the particular years' results for retrospective comment merely underlines the criticism that generally there was inadequate information presented to the Board about the Society's smoothing account, and a lack of Board policy on smoothing. He also referred to the practice of other offices during the current equity market collapse. I have not sought to speculate on the impact that collapse of the markets in and after 2001 would have had on Equitable if it had remained in the hands of previous management following established policies.

126. Ranson did not provide regular and adequate information to the Board about the business risks inherent in the general actuarial management of the Society, and in particular the business risks associated with the terms and conditions of the business written by the Society from time to time. In particular he did not inform the Board:

- i. Of management decisions in the period 1983-93 related to the recovery of the cost of annuity guarantees from terminal bonus¹⁷.
- ii. That the validity of the 1988 equation of annuity benefits for equal contributions to retirement annuity pensions and personal pensions respectively depended on the decision of 1982/83 that the cost of annuity guarantees would be recovered from final bonuses otherwise payable on retirement annuity pensions.
- iii. Of the relevance of the prospective differential terminal bonus policy to the gradual withdrawal of guarantees from new with profits business during the 1990s; or
- iv. Of the risks to which policyholders not entitled to annuity guarantees were exposed by the policies and practices adopted.

Ranson has commented that this is unacceptable criticism "in the absence of significant guarantees within the business", a comment that is unintelligible in the circumstances. He has asserted that the Board "would have been aware of the long-established approach that the guarantees... were managed through the bonus system", a comment for which I have found no support in the Board papers. He has denied that the decisions were management decisions, and at the same time contended that implementation was not something that merited report to the Board.

¹⁶ See chapter 3, paragraph 129, footnote 14. In his report for the Board meeting on 28 January 1987 Ranson explicitly recommended that "the £2m released from reserves be utilised to enhance various rates for recurrent single premium business at my discretion".

¹⁷ Ranson, along with other directors, has challenged the reference to the 'cost' of the annuity guarantees as misleading and objectionable. The expression was taken from Headdon's papers. In any event I consider that making good the capital deficiency recognised as arising from the *Hyman* decision is appropriately described as a 'cost'.

127. Ranson has also challenged the characterisation of the differential terminal bonus policy as providing for the recovery of annuity guarantees from terminal bonus, and has sought to justify the equal treatment of RAPs and personal pensions in the circumstances of 1988, and to relate them to other decisions on bonus policy. Changes were made to bonus policy in 1962 to reflect the differential incidence of tax, but that in my view had no bearing on the position in 1988. He has asserted that the articles of association gave the Board power to set distinct bonuses for each individual policy if it considered that appropriate. I consider that to be an inappropriate construction of the articles quite apart from the House of Lords' decision in *Hyman*. Ranson's other comments on this section challenge findings in fact for which I consider there is ample evidence, as set out in the body of the report.

128. In relation to the Society's regulatory returns, Ranson did not apply successive regulatory requirements requiring the valuation of:

- i. Guarantees explicit on the face of the with profits pensions business; and
- ii. Any options that were from time to time in the money, relative to the Society's primary obligations

As a result, the Society's regulatory returns failed to identify and value the growing guaranteed obligations that resulted from a combination of falling interest rates and lightening mortality experience. Such references as were made to these guarantees in and after 1994 (relative to the 1993 return) failed properly to disclose their nature and extent to the regulators.

129. In his representations, Ranson has contended that the publication of the Government Actuary's guidance in January 1999 indicated that there was doubt about the requirements of the regulations. Superficially that appears to be a fair inference from the fact of publication, and it has some support from GAD. However, the regulators' views were based on the clear terms of the legislation and regulations supplemented by GN1. Ranson has also commented that the Society's position was clear on the face of the returns and no questions were asked. On this matter, I prefer the evidence of the GAD witnesses who have pointed to the obscurity of the references in the returns. The returns were opaque and uncommunicative.

130. The intimation of a quasi-zillmer adjustment to the regulator in November 1992, affecting the valuation bases at that time, was clear, and should have caused comment. But Ranson's comments in schedule 4 to the 1994 and 1995 regulatory returns failed adequately to relate the adjustment made then and subsequently to acquisition expenses, and therefore failed properly to disclose the nature of the adjustment. The amended language of the 1997 regulatory return, while less opaque, did not disclose fully the nature of the adjustment. Further explanation would have been required for the returns to communicate the nature of the adjustment made in the resilience calculations. I note that Ranson has commented that Schedule 4 was written primarily for scrutiny by professionals at GAD. However, the form is part of the published financial statements of the Society, not a private communication.

Headdon

131. Ranson's successor as appointed actuary was Chris Headdon, who had joined the Society as an actuarial trainee in about 1978. He subsequently qualified and, in 1985 after circulating through a number of departments, joined the actuarial valuation department overseen by Ranson. Between then and 1997 when he succeeded to the post of appointed actuary, Headdon had a role subordinate to Ranson. Headdon was not appointed a director until 1999. He took over as chief executive on Nash's resignation in December 2000. From at least 1989 until 1997 Headdon was associated with Ranson in the provision of information to the Board on actuarial matters. He did not make good the lack of information and advice on actuarial matters referred to in the case of Ranson.

132. In November 1993, Headdon identified two alternative approaches to dealing with the annuity guarantee problem. He advised Ranson of the implications of selecting the option that was likely to draw less attention to the issue. That option failed to communicate fully the nature of the differential terminal bonus policy to policyholders. Headdon acquiesced in the implementation of that approach as Ranson's assistant.

133. Headdon has made extensive observations in relation to this finding. He has challenged the comment that there was a problem, suggesting that there was none before the *Hyman* decision. However, there would have been no litigation if there had not been a problem. Headdon has also emphasised his own subordinate role. I accept that he was subordinate, and I do not suggest, as he has alleged, that "every middle-ranking manager should resign on principle whenever senior colleagues do not fully agree with them on every matter outside of their area of responsibility". But he cannot object to responsibility for his own advice. Nor do I accept his contention that the selection of a bonus policy was a separate issue from how it was published to policyholders. That there are different processes is clear, but in a mutual society there should be no difference between the substance of a policy and what is communicated to policyholders about it.

134. From 1997 Headdon was responsible for actuarial advice. He continued to operate the quasi-zillmer adjustment in resilience calculations, which was inappropriate. He continued the differential terminal bonus policy. Headdon was responsible for engaging the mechanism of financial reinsurance to support the solvency position, although the treaty did not, and never was intended to, transfer material risk or result in any actual settlement of reinsurance claims. Rather it facilitated an accounting exercise that appeared to reduce net liabilities while leaving the Society exposed to the gross risk. Emerging reinsurance claims were offset by the reinsurer's right to future profits. Further the treaty was subject to a revolving limit of £100m of nominal reinsurance outstanding at any year-end. I make further comments on this topic below.

135. Headdon has commented that by the time he became appointed actuary Ranson's approach had been in use for four years without material query. That is true: Ranson's returns were opaque and the point was not identified by GAD. But, however it is defined, Headdon's personal responsibility was not avoided by reliance on Ranson's actions and experience. He also commented that responsibility for communications with policyholders remained Matthews'. That also is true. But communications were secondary to policy formation in this context.

Nash

136. Alan Nash succeeded Ranson as chief executive in July 1997, resigning in December 2000. In relation to the aspects of the Society's business that are material for the purposes of this report, I have found little cause to identify events and policies with Nash as distinct from other executive, and indeed non-executive, members of the Board. Though a qualified actuary, who occasionally initialled reports with Headdon, I was persuaded that he was not qualified by experience to make a material contribution to, and had no significant part to play in, the actuarial management of the Society. My comments on Nash are therefore generally the same as for the wider Board, but with particular emphasis on his responsibility for failing to ensure adequate and effective risk management systems were operated during his term of office. In particular he delegated the area of actuarial management to Headdon without such systems being put in place.

137. Nash did not ensure that the financial reinsurance arrangements, put in place by the Society to support its solvency position, were proper and effective as the treaty did not, and never was intended to transfer material risk. The characteristics of the treaty are referred to above and later in this chapter.

Audit

138. So far as it is material, it is not within the terms of reference to form or express any views on the performance by the auditors of their contractual or professional duties.

139. The Society has in process civil proceedings for the recovery of damages. Examination of the pleadings, the judgment of the High Court, the written arguments of parties in the Court of Appeal, and the opinions of that Court, and proceedings in other cases recently concluded, make it plain that my inquiry could not have undertaken the investigation of these issues. An inquisitorial process such as this could never satisfy the requirements for fair and reliable adjudication on parties' respective contentions.

140. Similarly, breach of professional duties is a matter for the professional bodies of which the relevant auditors were members at material times. The inquiry could not take to itself the role of a parallel disciplinary body.

141. There are two proper areas for discussion:

- i. The implications for the future assuming that what Ernst & Young did in the light of the knowledge they gained of the Society's affairs was a proper reflection of their professional and contractual duties; and
- ii. The scope of their knowledge of the relevant facts and circumstances.

142. So far as the second of these items is concerned, the auditors' knowledge is an important source of corroboration where the information recovered from them coincides with the inquiry's independent findings, and a focus for further discussion where there are discrepancies. The facts found by the inquiry on the basis of Ernst & Young's documents and oral evidence have been rehearsed in some detail, and have been taken into account in assessing other evidence relating to the Society's financial position over time.

143. So far as the first area is concerned, there are lessons to be learned for the future in any event. The lessons drawn will necessarily be conditioned by the validity of the assumption made, that what was done was proper performance of their duties. But that is inevitable.

144. There is inevitably an air of unreality about this approach. The High Court may in the end resolve the current litigation by deciding, among other things, that Ernst & Young were in breach of a duty owed to the Society. That would undermine any conclusion dependent on the hypothesis set out. It would not have a similar impact on any lessons for the future. The current controversy that is the focus for the litigation would require one to consider the future position whatever the outcome in the case against Ernst & Young simply because it reflects differences of view as to the duties of auditors.

145. Assuming, however, that Ernst & Young's position is acceptable, on which I express no view whatsoever, my conclusions are:

- i. There has been a comprehensive failure by industry and by standard-setting bodies over a long period of time to formulate and put into effect accounting standards for the preparation and presentation of financial statements relating to long-term business that reflect the realistic financial position of life offices.
- ii. Without adequate accounting standards relating to liabilities, including contingent liabilities, audit has been inhibited from effective reporting on life offices' financial statements as a whole.
- iii. In particular, failure to provide adequate accounting standards for disclosure and valuation of future terminal bonus payments has resulted

in published financial statements that failed adequately to reflect the realistic financial position of companies reported on.

146. Particular failures associated with practices identified in this report include, in relation to liabilities generally, the failure to require disclosure of the realistic financial position of the Society, and comparative analyses of liability valuations in Companies Act and regulatory statements respectively and in the office valuation. There is a clear need to inform policyholders, and shareholders in proprietary companies, of the relationship between the regulatory returns and the Companies Act accounts in a way that defines their respective functions and identifies the differences that result.

147. In the case of the Companies Act accounts there was a failure to identify and to quantify in an intelligible way differences arising from changes in assumptions, and a failure to relate the consequences to PRE. In particular, between 1990 and 1997 the Society's published financial statements failed to inform policyholders of the analysis of the movements in value resulting from the changes in actuarial assumptions, and failed to draw attention to resulting discrepancies between the policy values intimated to them and the relative liabilities reflected in the accounts.

148. The current audit approach, with delegation of scope of and responsibility for the actuarial function within a life office is deficient. The auditor has been in some instances over reliant on the appointed actuary (and indirectly on the actuarial profession's standards and guidance) for appropriate liability valuations for inclusion in the Companies Act and regulatory financial statements. One example of the risks inherent in this approach was the Society's failure properly to take appropriate account of its annuity guarantees and options. While the regulatory framework required such guarantees and options to be included in the actuarially determined valuation process, audit did not extend to reporting on compliance, and was inhibited from making appropriate challenge.

The Regulatory Regime

149. Throughout the period with which the inquiry has been concerned, prudential regulation of life insurance companies focused on a system of returns, generally and in the case of the Society, supplemented in and after 1991 by visits to life offices. (Equitable was among the first offices to be visited.) The returns required information relating to the long-term business of the Society in response to specific questions. It was through the medium of its returns that the Society was required to indicate, and place in the public domain, what was considered to be the essential financial characteristics of the business for purposes of regulation.

150. As understood by regulators, it was a central requirement of the performance of their function to ensure that individual offices' returns were compatible with the regulatory framework, while acknowledging that the relevant issue was whether the data reported reflected assumptions and decisions that were within ranges permitted by the regulations. It was considered that it was not a proper function of regulation to substitute the regulator's judgement of what was optimal from a regulatory standpoint for the judgement of the management. In relation to the content of the returns those views were valid and sustainable in my view.

151. However, scrutiny of the returns to ensure conformity with the current regulations in the way described did not exhaust the scope of regulation. The powers of intervention prescribed by statute were not defined exhaustively in terms of the regulatory requirements for the completion and content of the returns. I shall discuss the particular issue of PRE later. But it illustrates a point of some importance. The financial information required of offices in the returns of long-term business was focused on the contractual liabilities of the office. PRE was not limited to performance of contractual obligations. The concentration of regulatory scrutiny on the returns might raise questions whether PREs were or might be at risk. But the

resolution of such an issue would depend on inquiries that of necessity lay beyond the formal scrutiny process.

152. A decision to implement the regulatory obligations implicit in the 1973 Act by the established means of the scrutiny of returns was made by Ministers in the course of preparation of the Bill. At that time the major part of bonus allocation in with-profits business across the industry took the form of declared reversionary bonus, and terminal bonus was relatively undeveloped. The Society adopted terminal bonus in 1973. The net premium basis of valuation was particularly adapted to annual premium contracts, and, in general terms, contributed to the realisation of policyholders' reasonable expectations of future bonuses by providing for the release of surplus from which bonuses could be declared over the duration of the contract. In the circumstances, and for that time, the approach adopted and approved has not been the subject of serious criticism.

153. The paper-based approach persisted thereafter despite material changes in the approach to with-profits business generally, and in particular the progressive change in bonus mix towards terminal bonus as with-profits offices sought to compete with unit-linked and other innovative products appearing in the market. At all material times the information required in the returns in relation to the long-term liabilities of the with-profits fund was related to contractual or guaranteed benefits. The quantification of these benefits, as liabilities of the Society, required certification by the appointed actuary. Financial reporting systems were at all material times dependent upon the views expressed by the appointed actuary of the appropriate levels of the mathematical reserves generated by the with-profits business, and of the implicit items taken into account in form 9 in the computation of regulatory solvency.

154. GAD have told the inquiry that it was "the overriding principle of regulation and of supervisory monitoring" that "reliance should principally be placed on the appointed actuary, who was close to the company and had a professional responsibility to monitor its financial position on a day-to-day basis and to establish technical provisions". GAD have also observed that this approach has been a major factor contributing to the strength and vitality of the UK life industry since its introduction in 1973. Similarly those responding on behalf of the Treasury have told the inquiry that:

"... unless the actuary was acting in some way contrary to the regulations, it was not the task of the regulator (or its actuarial advisers) to substitute its judgement for that of the appointed actuary in areas where the appointed actuary had a clear professional responsibility."

155. I do not dispute that there has been an advantage in not seeking to prescribe a fixed actuarial approach, although I have commented already that the appointed actuary's professional responsibilities were in the first instance towards the board of the insurance company. The appointed actuary's regulatory responsibilities were more limited, and in particular were constrained by the valuation regulations that were the responsibility of the regulators. Moreover the variation in experience and status of appointed actuaries within companies meant that regulators continued to have a responsibility to assess the reliance they placed on the appointed actuary in the particular circumstances of the company concerned. That the system placed too great a reliance on the appointed actuary in practice appears to be recognised by FSA in their proposals for reform of this role. From the narrow perspective of Equitable, I can say that this reform seems amply justified.

156. In the circumstances there was a heavy responsibility on the regulators to monitor, or to procure the monitoring of, the valuation of the mathematical reserves and the quantification and treatment of implicit items in order effectively to assess the solvency position of the Society in terms of the valuation regulations. I shall return later to the effectiveness of the approach as a means of monitoring the performance of life offices as business practice evolved, after I have commented on actual scrutiny as it affected the Society.

Structure and Resources

157. Until the late 1990s, the regulatory system involved the delegation by the responsible authority (successively DTI, HMT, and FSA) to GAD of the essential task of actuarial scrutiny of life offices' returns. This persisted until FSA brought the separate elements together and began to implement an integrated regulatory system. Until that reorganisation, GAD reported to the regulator, initially in terms of informal arrangements and later in terms of service level agreements that defined the scope of the delegated duties.

158. The approach to regulation was reflected in the resourcing of the DTI insurance division throughout the period. DTI insurance division was ill-equipped to participate in the regulatory process. It had inadequate staff, and those involved at line supervisor level in particular were not qualified to make any significant contribution to the process. Insurance division regulators were fundamentally dependent on GAD for advice on the mathematical reserves, implicit items, technical matters generally, and PRE, and were not individually equipped with specific relevant skills or experience to assess independently the Society's position in these respects. Given the volumes of work to be handled, which extended far beyond the regular scrutiny of returns, higher-grade officers had little opportunity to become involved in routine regulation. HMT's term of responsibility was transitional, and, while preparations for change were put in hand, there was no material change of approach during it, although I note that a need for greater regulatory resource had been identified at that time. For all practical purposes, scrutiny of the actuarial functioning of life offices was in the hands of GAD until the reorganisation under FSA was in place.

159. GAD actuaries were held in high regard by the regulators. They enjoyed the advantages and shared the disadvantages of all who are members of small introspective and exclusive professional groups. They had access to current and developing thought within the profession. They participated in discussions, and in particular took part in professional committees reviewing practice and recommending future policy. Individual members of the department participated in professional projects aimed at developing actuarial methodologies appropriate to changing circumstances.¹⁸

160. However, from a wide reading of reports and other communications within GAD and between GAD officials and regulators and others, it appears that they were often inhibited by their understanding of what was acceptable within broad and ill-defined standards of practice. Although GAD may point to specific instances where challenges were made, for instance on mortality assumptions or on Ranson's use of an "average valuation interest rate", it appears from my reading of the files that there was a tendency to judge according to the lowest common denominator of prevailing current views among actuaries, and appointed actuaries in particular, on whose individual judgements heavy reliance was placed. As a result, GAD did not appear to have challenged sufficiently the opinions and assumptions underlying actuarial valuation. Although GAD brought in a more detailed style of scrutiny in the early 1990s, the standards of scrutiny still impress me as complacent, lacking challenge, and hesitant in criticism and in following up on any criticism made. This was, indirectly, reflected in a lack of robustness in the regulatory process.

161. In the course of maxwellisation, it has been represented by senior regulatory officers that Government required a 'light touch' approach to regulation, and allocated resources accordingly. Increased resources, it was said, might have improved the chances of identifying problems. I was urged to take into account the

¹⁸ In representations to the inquiry, GAD have drawn particular attention to the new, more detailed style of scrutiny reports introduced from 1993, their participation in professional working groups such as those looking into guaranteed annuities and PRE, and their active promotion of dynamic financial analysis, which contributed to the introduction by the profession of financial condition reports as recommended practice.

political climate that prevailed for most of the 1990s when the Government's objective was to deregulate, to reduce regulatory burdens on business, to avoid interference in private companies, and to let market forces prevail.

162. There have also been representations from individual regulators to the effect that reforms were introduced, within the legislative framework that existed, but that Ministers had repeatedly ruled out primary legislation in this area. It has been suggested that the likelihood of proposals for change winning ministerial approval was reduced further by Ministers' perception that life insurance supervision was a success: there had been only one insignificant life company failure in twenty years. It was said that problems affecting particular companies were identified in time, and solutions found. Virtually no primary legislation in the regulatory area for which DTI was responsible was taken forward by Ministers. I accept that there were specific proposals for change that Ministers did not pursue. And the inquiry has seen evidence that aspects of the regime were reviewed. For instance there was a review in 1990 of the powers under the 1982 Act by comparison with the more recent powers under the Banking Act 1987. But I saw no 'wish list' of legislative amendments that identified fundamental structural reform as a possible subject for legislation.

163. However, the observations appear to me to miss the point. If regulators had identified the need to amend the regulatory system, for example to require realistic accounting in the way now proposed by FSA, and Ministers had failed or refused to pursue proposals for change, the ground for criticism of the department would have remained the same. The balance of individual responsibility would have changed. But no relevant proposals for change were made, and the ground for criticism of the department remains the same. Whether that affects individual responsibility depends on one's assessment of Ministers' general policies. But my concern, in terms of the remit, has to do with identification of any deficiencies I have found and with appropriate recommendations for future change. Allocation of responsibility as between Ministers and officials, while an interesting diversion, is not of the essence of the exercise.

Regulation of the Society

164. I have already set out my conclusions as regards the financial management of the Society. By the time the annuity guarantee issue came to prominence in the late 1990s, there was already a history of chronic and persistent over-allocation of bonus and consequent over-payment of claims that left the Society in a seriously weakened position. That weakened position was more and more manifest in the measures the Society was taking to bolster its solvency position.

165. Before turning to specific aspects of the Society's financial position, I should note that I have received various representations to the effect that the focus of regulation was on solvency, and that the Society was at no point insolvent. I do not dispute that solvency was the focus, but there are reasons why it should not have remained so. First, industry trends were increasingly taking the reality of with-profits business away from a narrow test of solvency, and towards a situation in which PRE was increasing important. As I will discuss below, the focus on solvency did not adequately address this. FSA's proposals for realistic accounting are clear recognition of the importance of looking beyond a narrow concept of solvency. Second, emphasis on the Society's continuing solvency ignores the fact that it is a mutual society, whose members' liability is not limited by its articles of association. A regulatory system that aimed simply at avoiding insolvency would fall far short of the objectives that the public would assume for it, and short indeed of the objectives that I believe Parliament set for it.

166. Within the framework of the existing regulatory structure, in relation to the treatment of contractual or guaranteed liabilities, there are six areas of specific concern about the regulatory response to the Society's practices in relation to the

computation of its mathematical reserves and the computation and treatment of the implicit items. These are:

- (i) the interest rate differential (between the bonus rate projected forward and the rate of return used to discount liabilities back to present values) between 1990 and 1997;
- (ii) the quasi-zillmer adjustment (through which acquisition costs for recurrent single premium business were annuitised) from the early 1990s;
- (iii) implicit items for future profits employed in and after 1994;
- (iv) the subordinated debt;
- (v) the GAR liability valuation, and
- (vi) the financial reinsurance treaty.

Individually and together the steps taken or omitted to be taken by the Society in respect of these items supported regulatory solvency of the Society. As a consequence of these practices, some of which were at the expense of, or in anticipation of future profits, future maturities and other claims were put at risk. The treatment of these factors served indirectly to conceal the growing weakness of the Society in realistic terms.

167. In view of representations made in the course of maxwellisation of senior regulatory officers, it is necessary to spell out more fully the nature and impact of the factors identified, most of which were within the limits allowed in the valuation regulations and published guidance.

Interest Rate Differential

168. Ranson had pursued a consistent practice of equating the bonus rate projected forward and the valuation discount rate in his bonus reserve valuation, and reflected the valuation discount rate in the net premium valuation appended to the returns. In 1990 he introduced a 1¼% differential deliberately to release surplus. Similar rates released further surplus in 1991. Balance between these rates was nearly restored in 1993, when there was only a ¼% differential. In 1994, another year that showed a loss in realistic terms the exercise was repeated, and balance between the rates, in accordance with prior consistent practice, was not restored until 1997.

169. As a result, recurrent single premium business was valued at less than face value and surplus was anticipated, in conflict with the accepted actuarial opinions expressed by GAD officials. The Society's liabilities were depressed in value over two successive periods of years at the start of which there had been significant losses in market values of assets. Equitable's practice was accepted on the sole basis that the valuation discount rates, per se, could be justified under existing regulations by reference to yields on selected assets, without consideration of the longer-term implications of adopting the methodology.

170. In the course of maxwellisation, it has been represented by senior regulatory officials that DTI was aware of the change, and that GAD had considered it and thought it permissible and reasonable in the circumstances, that is in the adverse investment conditions of the time. In their own representations GAD have observed that the practice did not conflict with the relevant regulations in force at the time, and therefore there were no grounds for challenge. Whatever the judgement reached at the time, it is clear, on a review of the Society's realistic position, that the weakening that resulted had serious long-term consequences that would have been disclosed on a broader review than that adopted at the time. The contemporary view reflected a concentration on the global position of the Society that gave inadequate weight to inter-generational implications of decisions.

171. It may be helpful at this point to illustrate the significance of all these items by reference to the interest rate differential. In the regulatory return, the change of practice introduced in 1990 released £557m of surplus in a year when the Society had suffered negative investment returns, and was, indeed, a mathematical product of the recognition of the loss of equity value. The Society was enabled to allocate a substantial rate of return to policyholders for 1990 and 1991. This inflated policy values relative to available with-profits assets. On becoming a claim, policy value was crystallised and whatever un-guaranteed elements there had been, in the form of accrued terminal bonus, became contractually due, subject to any market value adjustment that was applicable and was applied at the time. The total adjusted value left the with-profits fund. Claims values were inflated in this way throughout the 1990s, and on into 2001. Capital was eroded and the cost fell on continuing policyholders. The fund overall was weakened irrespective of whether fresh surpluses emerged in succeeding periods. The failure to appreciate that a change of valuation assumption of this kind had real implications for different generations of policyholders as well as computational implications for the with-profits fund as a whole appears to persist in the representations I have received.

Quasi-Zillmer Adjustment

172. In 1992 GAD had information that the Society's valuation bases included an adjustment in valuing recurrent single premium business that released money at the outset in a similar way to the release produced by a zillmer adjustment. In a letter dated 6 November 1992, Ranson commented on the practice in relation to the 1991 valuation. The point was not pursued in GAD's response on 3 March 1993, and appears to have been dropped at that time. Thereafter there were opaque references to the practice in returns for 1994 and 1995 and more explicit references from 1997. After the correspondence in 1992, the nature of the adjustment as a zillmer-type adjustment was not identified until late in the scrutiny process on the 1999 return. The practice came to be identified at that stage as a quasi-zillmer adjustment of ½% of fund in the resilience calculations, and was eventually held by GAD to be irregular in relation to the financial statement at 31 December 1999, when the amount involved was approximately £950m. The accumulation of a credit against the Society's liabilities based on the assimilation with a zillmer adjustment had from the early 1990s inflated its solvency position. By late November 2000 the quasi-zillmer adjustment, which had been disclosed in Ernst & Young's report for the sale process, had been the subject of discussion between regulators and potential bidders.

173. The information provided by the Society to GAD, apart from the letter of 6 November 1992, was not clear until Headdon was challenged on the 1999 return. The GAD actuary engaged in the correspondence with Ranson in 1992 declined to complete the interview process with the inquiry, and I have received no other explanation of the failure to follow the point up at that time. On the information available from the documents, GAD had intimation of the practice in November 1992. It was suggested by one witness that Ranson was told the practice was unacceptable and agreed to discontinue it. But I have not traced any record of the challenge nor of the agreement to desist, and it is now clear that Ranson did not abandon the practice in the early 1990s.

174. This is an area where the lack of powers of compulsion has prevented me from following up a detailed study of the background to an issue. However, the general effect of the adjustment is reasonably clear; its unacceptability was affirmed in the end; and there is sufficient evidence that one manifestation of Ranson's approach was known to GAD in November 1992 at the latest. I cannot accept the representation during the maxwellisation process that GAD was not aware of the practice and therefore did not notify DTI of it. This seems to me to be a clear example of the system failing to follow up information that was relevant to financial regulation.

175. It has also been suggested in the course of maxwellisation that in 2000 the Society was able, by re-hypothecation of assets for resilience purposes, to off-set the reduction in the resilience reserve that arose on correction for the quasi-zillmer adjustment. To a value of £750m that was the case. However this misses the point. Over the years the Society had avoided structured hypothecation of assets in order to maximise the scope for discretionary variations in benefits allocated to different policyholder cohorts. It is no answer to the criticism of practice throughout the 1990s that the Society had resort to yet another actuarial technique to reduce liability valuation, in place of the unacceptable quasi-zillmer adjustment, in respect of solvency in 1999.

Future Profits

176. The Society was allowed orders under section 68 for future profits implicit items on what appears to me from the record to have been a mechanistic approach that failed to test the actuary's certification of the availability of the future profits, given the nature of the Society's predominantly RSP business. The supporting projections were not sought. While this criticism is general, it takes on greater force in the later 1990s when the Society's dependence on the implicit items was greater.

177. The Society's practice has been discussed in chapter 6. The actuarial certificate required to support an application for a future profits implicit item had to state that the sum sought, as well as meeting the arithmetical requirements of the regulations, did not exceed the present value of the profits expected to arise in the future on in-force business. The valuation of the in-force business involved assumptions about discount rates and other factors that were intended to be inherently prudent. In the Society's case, it appears that the 'future profits' were taken to arise from the difference between the implicit assumptions and more realistic expectations of future returns.

178. As applied throughout the relevant period, the assessment of present value took no account of actual anticipated financial conditions generally, as affecting the particular office. The approval of an implicit future profits item in September 2000 after the Society had lost the Hyman case and was in the course of a sale process highlights the artificiality of the regulatory requirements. By that time it was known that the Society itself would not continue in business: it would either be sold or closed to new business. Even in the event of a successful sale, the Society would be a new entity that required assessment of its current business according to its altered financial position. But in the event that the Society had to close to new business, as in fact it did, there would be no basis on which it could have been assumed to have a future maintainable flow of surplus from in-force business, whatever the margins in the valuation at 31 December 1999. Investment policy would have been constrained by solvency requirements. The quantum and incidence of expenses would have altered. The potential for future profits to be realised would be adversely affected by the altered circumstances in which operations had to be carried on. One element of a full and proper assessment would have been the value of the margins in the valuation process. But the circumstances relevant to the Society's ability to realise those margins as profit would have changed.

179. I have received extensive representations that the grant of a section 68 order for the future implicit profits item in September 2000 was proper and in accordance with the regulations. I do not suggest that that was not the position. Indeed it appears that in the context of current guidance and the regulatory framework in force regulators could not have done otherwise, at least without considerable investigation of the background to the second part of the actuarial certificate which was not then the practice..

180. I consider, however, that there is at least an air of unreality in a system that prescribes valuation criteria, to ensure prudence in the interests of policyholders, and then proceeds to allow for the reduction of the prudent margins implicit in the valuation exercise on an accounting basis that allows one to ignore fundamental structural changes in the business that must impact on the ability to realise, as

profit, the values off-set against the liabilities as initially calculated. Nor is it an answer to point out, as some maxwellisation responses did, that the certification requirement represented a stricter requirement than that prescribed in the 1st life directive. Failure to question the robustness of the underlying assumptions meant that this requirement was ineffective.

181. The effect of the order has been described in maxwellisation representations of senior regulatory officials as follows:

“In effect, the implicit item simply recognised that there were margins in the basis for valuing liabilities in respect of existing business, and that these could be released to cover unexpected future losses. Of course, any such unexpected losses would also have an effect on the level of future bonuses that could be payable. However, this was a natural part of the operation of the business whereby policyholders would participate in the overall profits or losses.”

As I understand it, the margins were released in the period in respect of which the order was granted, and by that means ceased to be available within the valuation to cover unanticipated future losses. Current recognition of the implicit profits increased the exposure of continuing policyholders to future risk.

182. However, perhaps the more important point that arises is the general one that the more a life office relies, and has to rely, on elements of value such as this to maintain regulatory solvency, the greater the need for regulators to examine closely its realistic financial position overall in terms of their powers of intervention.

Subordinated Debt

183. The Society was authorised to ignore subordinated debt in calculating its form 9 solvency position. The authorisation was within the scope of the relevant regulations and guidance. I do not criticise any of the formal steps taken or the propriety of the order granted.

184. However, as with the other items, the Society's interest in raising this form of debt should have alerted regulators to the Society's weakening position overall. It was an extremely complex and expensive exercise. It raised a small sum relative to the Society's resources at the time. Its purpose was to support regulatory solvency in anticipation that that would come under stress. There was no indication that it was seen as an indication of impending solvency problems.

185. I am also concerned that the departmental treatment of the transaction suggested a lack of appreciation of the need properly to protect members of the Society from liability for the debt. The Society's members have unlimited liability for its debts to third parties. Regulators failed adequately to consider whether or not members might ultimately be personally liable for the debt so far as it was not recovered from the Society. The Society intimated to regulators on 10 July 1997, in a proposed amendment to the offering circular, a provision designed to provide protection. There was no response to the proposal. Legal advice was not taken on its effectiveness, or on the effectiveness of the arrangements generally to protect members as individuals.

186. Departmental records show that an erroneous view was held that being a member of a mutual did not involve any obligations other than the obligation to pay premiums. It has been represented by senior regulatory officials that that was not the general view, but an error on the part of a junior official. However, it was the view communicated in name of the department to German regulatory officials following a request for advice. It is a matter of some surprise that responsibility for an inter-governmental representation was committed to a junior official without the degree of supervision that would have identified the error and corrected it, if indeed the error was specific to the individual involved.

187. The subordinated debt supported regulatory solvency from the date it was issued, and consistently thereafter. It was approved when the Society was moving towards a weakened position overall. The purpose of this class of hybrid capital was

to provide an equivalent of equity capital for the long-term operations of insurance entities. In the case of Equitable there were short-term objectives related to support of solvency that should have alerted regulators to the Society's weakening position.

GAR Liability Valuation

188. Having eventually taken a strong position on the interpretation of the relevant regulations and the implications for Equitable's liability valuation, GAD and FSA did not impose the intended requirement for near 100% valuation and tolerated significant discounting of the liability on take-up rate hypotheses that were inconsistent with the official view.

189. But before that stage, regulators and GAD were told in November 1993 that the Society did not reserve for its guarantees, considering that they did not 'bite'. The information was not followed through and did not, as it ought to have done, inform the scrutiny of the 1993 return in 1994.

190. It has been represented to me in the course of maxwellisation that for all practical purposes DTI and GAD had no knowledge of the existence of the annuity guarantees, or of the Society's treatment of them by means of the differential terminal bonus policy, until 1998. It has been said that had they known of them, especially after the renewed fall in interest rates in 1995, there would have been scope for the problems to have been addressed at a significantly earlier date. I agree with the latter proposition: there would indeed have been scope for the problems to have been addressed earlier. But I do not accept that the existence of the annuity guarantees was unknown to the authorities until 1998, in light of the specific information provided in 1993. There is acceptable evidence that regulators knew of the general problem with guarantees in 1993. Nor do I accept that the information supplied by Ranson in 1993 (as recorded by the regulators) was too garbled for its significance to be apparent. At the least it should have prompted more probing questioning.

191. More generally, the Bolton Committee on annuity guarantees was set up in January 1997 by the profession because it had been recognised that annuity guarantees in older business were becoming valuable and because up to that date there had not been an attempt to set appropriate reserving standards in the light of the Insurance Companies regulations. It is clear that the existence of a problem had to have been recognised by the profession at the latest during 1996. Given their access to the returns of the whole industry it would seem surprising if it were the case that, as has been represented to me, regulators were not on notice of the annuity guarantee problem at all until 1997. This suggests either a wide-spread conspiracy to conceal the problem from regulators, or a lack of insight into the reality of the regulated entities' businesses. Since I have acceptable evidence that particular offices recognised their annuity guarantee obligations and made provision in their mathematical reserves for their value, the notion of an industry-wide conspiracy of silence must be rejected.

Reinsurance

192. Reinsurance is well-established in all forms of insurance. Its traditional function has been to redistribute total risk, passing all or part of the insurer's risk to the reinsurer by conferring a right of recourse against the reinsurer on emerging claims. In that case, the insurer's liabilities and technical reserving requirements are reduced.

193. In the course of maxwellisation, I have received representations from senior regulatory officers emphasising that that was not the nature of the contract in Equitable's case:

"The treaty was... a financing operation. This was known and understood at the time by the regulator. In the Society's case the reinsurance treaty was an appropriate way of 'phasing in' the impact of the higher level of reserving that HMT rightly and firmly insisted on. It was a means of ensuring that the

resultant cost, in the form of bonus cuts, was not imposed on a single generation of policyholders whose policies matured that year, but was instead spread over a period of years. It provided that the Society could draw down funds in years then the take-up of GARs exceeded a stated level with repayment to be made from future emerging margins. ...

Thus the “risk” the treaty was intended to meet was not so much an increase in the take-up of GARs ..., but rather the non-emergence of margins in the future. Increase in GAR take-up was the trigger for drawing down funds...

These reinsurance agreements then fall to be valued under the relevant regulations for the valuation of liabilities. Where these regulations allowed a value for the reinsurance agreement, then a firm and its Appointed Actuary can legitimately take credit for this agreement in its financial returns...”

I have not been able to identify such an analysis in the documents reviewed, but I am prepared to accept it as the officers’ position at the time

194. Regulation 64 of the Insurance Companies Regulations 1994 provides that in valuing liabilities account shall be taken of “any rights under contracts of reinsurance in respect of long-term business”. As apparently understood by regulators, the Equitable/ERC treaty did not confer any rights in relation to the current long-term liabilities of the fund. If it did not transfer risk and confer any rights on the Society, it is difficult to see how it could be regarded as reinsurance for the purposes of regulation 64, never mind justify the level of credit that was given to it. Designating the contract as a reinsurance treaty was not conclusive as to its substantive effect. In those circumstances the question of whether the side letter discussed in the full account of the reinsurance topic ought to have limited that credit is an irrelevance in terms of the regulatory assessment of the Society’s financial strength.

195. However, on a more general basis the effectiveness of the treaty to support Equitable was questionable. In the first edition of the treaty, cover extended only for so long as the Society’s bonus practice remained unchanged, which meant that it would not apply in the event that the Society lost the *Hyman* litigation. The regulators appeared to have proceeded on the assumption that the *Hyman* litigation would resolve itself in favour of the Society. Even without the benefit of hindsight, the contingency that the Society might lose the case, undermining the reinsurance cover, should surely have been regarded as material. Regulators required that the contingency of losing *Hyman* be noted. However, it was not reflected in the value that was taken into account.

196. Further, the nature of the treaty meant that to the extent that liabilities for the reinsurer emerged, the reinsurer would have a claim on future surpluses on the fund, and in that way the treaty, like the other items discussed above, supported present regulatory solvency at the expense of future generations of policyholders. In essence the treaty was not dissimilar to any facility agreement that could be drawn on, subject to an obligation to repay the sums drawn down. It would be unusual to treat the un-drawn balance of an overdraft facility as an asset.

Terminal Bonus

197. The comments so far relate to the regulatory system as it was developed and applied in practice. Notwithstanding various representations claiming the contrary, up to the end of the inquiry’s period of interest the system was geared in practice to the assessment of regulatory solvency almost exclusively by reference to contractual or guaranteed liabilities. In the parlance of the Society’s documents and practice, ‘contractual’, ‘guaranteed’ and ‘consolidated’ were synonyms describing the situation in which a policyholder had a contractual right to benefit, either in the specific terms of his contract or through the operation of the mechanism of declaration of bonus by the Society’s Board in terms of the articles of association.

198. From about 1983 Equitable began progressively to shift the balance within its bonus mix from guaranteed benefits to un-guaranteed terminal, later final, bonus. This reflected a general trend within the life industry, though the balance varied from office to office. The trend in the case of the Society was associated with a parallel trend towards ever-increasing allocation that initially eroded its explicit reserves for future reversionary bonus held at December 1982 until they were exhausted by 1985, absorbed general reserves in 1986 and 1987 to supplement current surplus, and by 1987 at the latest brought the aggregate policy values in the with-profits fund over the value of the available assets at market value. Despite the good returns of 1989 that position was not wholly reversed in that year. Thereafter the adverse results of 1990, 1991, and 1994 coupled with over-allocation of policyholder returns resulted in a position in which the aggregate policy values in the with-profits fund were never again covered by available assets.

199. This state of affairs was not disclosed by the returns because total policy values reflected accrued final bonus for which information was not sought. Regulators and GAD obtained information from time to time about the overall position. For example information was provided for the period 1989 to 1991 in the context of section 68 applications. But there was no consistent provision of relevant data, and none was sought.

200. Concentration on the contractual or guaranteed liabilities arising under with-profits contracts resulted in financial statements that failed to take account of future liabilities that would crystallise in respect of terminal or final bonus payments on claims. Such payments were accounted for on a cash basis, irrespective of their absolute or proportionate value relative to total claim value. Final bonus, from its introduction by the Society as terminal bonus in 1973, escalated through the 1980s and 1990s from being a low-level benefit of relative insignificance in total policy proceeds, to become a major component of importance and value and one of the defining characteristics of the Society's with-profits business.

201. The regulatory system remained in force, unaltered in this respect, throughout the reference period. In the case of Equitable, the approach of GAD and regulators remained the same after December 1994, when they were aware that the Society's financial position was weak and that there was a need for vigilance in scrutiny and supervision. Discussion of total policy values, for example in November 1996, was superficial and lacked challenge. A particular aspect of setting aside total policy values was failure to make any relevant inquiry as to the smoothing parameters, in terms of cycle and proportion, employed by the Society from time to time. In that way regulators and GAD were left without information whether the smoothing practice was based on reliable assumptions as to future trends. Had they made relevant enquiries, the lack of any coherent smoothing policy would have been apparent.

202. The systemic failure to require life offices generally, and the Society in particular, to account for accrued final bonus in advance of payment, especially in and after 1989 when the Society adopted the practice of publishing policy values on an annual basis, resulted in the regulatory returns becoming progressively less relevant as a reflection of the business actually carried on by the Society. At no time during the reference period, and indeed at no time until the new regulatory regime under the Financial Services & Markets Act 2000 was instituted, did regulators devise amendments to, or propose to modify, the regulatory requirements so as to require the Society to account, for regulatory purposes, for the characteristic transactions of the business.

203. This was a particular deficiency in the case of the Society. Regulators and GAD were informed by the Society of the characteristics of its new bonus system as applied in and after 1989; they were aware that a total growth rate was allocated on policies and that a part of that was designated as guaranteed bonus; and they were told that the system distinguished the Society from the practice of others in which

separate declared bonuses and final maturity bonuses were aggregated to determine policy proceeds, to the extent that GAD's questions based on general practice were dismissed by the Society as irrelevant. The uniqueness claimed for the Society's approach should have alerted regulators to the need to consider whether the unique attributes of the practice created unique risks requiring particular scrutiny. However, the Society's uniqueness was taken, generally, to be sufficient explanation of its deviation from industry norms.

204. As described by the Society, total policy values were central to the presentation of its results to policyholders, and were an obvious and necessary focus of regulatory interest if the Society's ability to sustain current practice into the future (especially in and after 1990) was properly to be monitored. No clarification of the Society's explanations and contentions was sought. Total policy values were not monitored. When the issue was discussed in November 1990, no attempt was made to recover the documents issued by the Society. Readily available were the bonus notices and 'dear policyholder' letters issued to members, the annual accounts, and other explanatory material discussing the new system.

205. Regulatory practice in this respect reflected the requirements of the current regulatory structure. But it seems not unreasonable to suggest that those in control of any supervisory regime have a duty to monitor the conduct of regulated businesses and to take steps to ensure that the systems of regulation that are in force and enforced remain relevant to the changing requirements of the industry. If that is not done, there is a risk that regulation will become out-dated and ineffective, and that it may of itself tend to promote practices that take advantage of its deficiencies. Specifically in this case, freedom from active monitoring of accrued terminal bonus encouraged the Society's drift towards un-regulated final bonus, and exposed it to the risk of over-allocation of returns to policyholders, with a particular impact on current claims, to the detriment of continuing and future policyholders' interests.

206. With the implementation of the third life directive¹⁹, and following on from the report of the *Groupe Consultatif*²⁰ in 1990, there was an opportunity to make domestic provisions, as permitted by the directive and encouraged by the report, which would have required prudent reserving for, or some realistic account to be taken of, final bonus. This would have exposed the weakness of the Society at a much earlier stage and would have prompted corrective action. DTI did not take that opportunity, taking the view instead (according to representations on behalf of the Treasury) that "some appropriate allowance should be made implicitly in the parameters of the system". The UK regulations implementing the directive left the position as it had been previously.

207. There were other consequences of this approach. In particular, in 2000 FSA and GAD were incapable of making an independent assessment of the Society's prospects of sale because of their lack of knowledge and understanding of the totality of the Society's business.

208. Representations made in the course of the maxwellisation process have challenged the thrust of this analysis. Reference has been made to advice sought from counsel in 1987, and to the attitude of the insurance industry to implementation of the 3rd life directive. That advice was sought and that the insurance industry was opposed to recognition of accruing terminal bonus is not open to question. But there was a need to be met, and nothing was achieved in the way of modification of the system to meet that need. And the analysis of the events leading to the financial position of Equitable in 2001 has identified the results of that deficiency.

209. The same applies to the claim in GAD's representations that terminal bonus was subject to regulation through the responsibilities of the appointed actuary. I

¹⁹ Council directive 92/96/EEC

²⁰ See chapter 10, paragraph 22.

note their view that total policy values were “not a natural focus of regulatory interest” during this period, but that despite this information on total policy values was collected. I accept that information was obtained from time to time, as I have recounted in this report, but this was not done consistently and, most importantly, the information was not used to form a realistic appraisal of the Society’s financial position and its approach to allocating bonuses.

Policyholders’ Reasonable Expectations

210. Independently of the regulator’s obligations to review the financial statements of the Society, it was at all material times its obligation to consider whether the interests of the policyholders and potential policyholders required the use, or the consideration of the use, of the powers of intervention conferred by successive Insurance Companies Acts. Until the reorganisation under FSA, which will result in material change if implemented, the forms and statements required in the annual reporting process were not designed at any time to elicit information relevant to regulatory intervention, except in respect of solvency. In particular, the forms and statements at no time sought to elicit information necessary to enable regulators to form a view on whether the reasonable expectations of policyholders and potential policyholders would be likely to be met or frustrated. The questions introduced latterly would not have elicited relevant specific information.

211. The power of intervention on the ground that the office was unlikely to be able to meet PRE was sought by DTI, the statutory provision was drafted by DTI, and Parliament was pressed to grant wide discretionary powers including this power by DTI. Extant departmental files set out the background and made clear and explicit the intention that there should be a power related to expectations of non-contractual benefits. Despite that background, the records disclose repeated references to the lack of a statutory definition as apparent justification for inaction on PRE grounds.

212. Until 1993 and the GAD bonus survey there was no attempt, independent of the returns, to collect and assess information related to regulated entities’ bonus practices. After 1993 there was no attempt to assess whether the Society had created reasonable expectations that were likely to be frustrated until the beginning of 1997, when a project was begun and then discontinued prematurely, with the result that at no time during the material period did regulators carry through to completion a study of PRE that might be considered to have been generated by the Society’s communications and practices. This was despite a clear recognition of the relevance of these factors to the statutory test of PRE under the Insurance Companies Acts. As it was, regulation failed to address the issue of whether there were grounds for intervention in the Society’s business at any material time.

213. The need actively to monitor PRE was underlined by the limitations inherent in the regulatory returns system. The more limited the testing of regulatory solvency by reference to contractual benefits, the greater was the requirement to consider the reasonable expectations of policyholders and potential policyholders that were not secured by present contractual rights.

214. Thus, potential policyholders contemplating investment in a with-profits policy with the Society would have been entitled at any time during the 1990s, having regard to the Society’s publications, to expect a return at maturity that reflected the earnings on his contributions over the duration of the policy, subject to some smoothing. The Society’s regulatory solvency position would not have discouraged that view. However, the Society’s realistic position would have indicated that there would be, for the indefinite future, a prior charge on the investment returns on that policyholder’s contributions to compensate the with-profits fund for prior over-allocation of returns on with-profits business. In the context of a well-defined smoothing policy that risk might have been acceptable. Regulators were never in a position to form a view on the issue, and therefore could not form a view whether the conduct of the Society’s business was such that policyholders’ reasonable expectations were likely to be fulfilled.

215. GAD and the regulators persisted in a reactive stance in respect of PRE when, by 1998, there were serious concerns whether the Society could meet expectations. This represented a major deficiency in the regulatory structure and the systems in place to enforce it. In day-to-day regulatory practice, officials operated within the constraints imposed by the existing system, and they had no alternative but to do so. But they were uniquely placed to understand how, over time, the Society's business was conducted. They did understand that the Society was weak.

216. Regulators were also well-placed to influence the reform of the system to meet its major deficiencies. In the course of the maxwellisation process representations have been made that from the early 1990s there was significant activity in relation to ensuring respect for policyholders' reasonable expectations in relation to demutualisations and other major reorganisations. Again that was clearly the case. Indeed the factors then identified as bearing on PRE were generally those that I have sought to highlight in discussing the subject. But extension of the exercise to offices that were not engaged in major reconstructions was not evidenced by the record, and it is that area that has caused me concern.

217. It was by Ministerial decision that it was resolved, in accordance with GAD's wishes, that PRE would be monitored from the annual regulatory returns. Since no specific provision was made in the returns, at least until 1996, for the provision of any information material to PRE it was left to the appointed actuary to volunteer information on which to judge whether the office was likely to be able to meet PRE. That position did not change materially in 1996. In the case of an office such as Equitable, in which the appointed actuary was also chief executive and reporting actuary for Companies Act purposes, the scope for differences of opinion whether the bonus policy of the office was consistent with policyholders' reasonable expectations was not great. In such circumstances it is not an adequate response for GAD to say in their representations to the inquiry that the regulators and GAD were not responsible for distribution policy.

218. When Equitable's practices in dealing with the annuity guarantees came to be of interest in 1998 and later years, regulators and GAD had to approach the issues raised as novelties that challenged them both in principle, and practically, because they had no relevant material by reference to which to form a view. The same position would have arisen in relation to accrued final bonus had they come to terms with the emerging view that PREs could arise in relation to policyholders' interests that were not contractual.

219. Only with FSA's approach to realistic balance sheet accounting (due for implementation in 2004) will regulators begin to deal with the issue, in the context of the test of treating policyholders fairly.

220. In their separate representations, GAD and the Treasury have told the inquiry that the relevance of terminal bonus was always recognised by GAD and the regulators, but that PRE in respect of terminal bonus was not created by the Society's bonus practice. They point to the notes that stated that terminal bonus was not guaranteed. However, GAD and the Treasury also recognise that PRE was not restricted to guaranteed benefits. It is not necessary to conclude that policyholders would have reasonable expectations of receiving a precise amount of bonus to take the view that reasonable expectations would still have been created. The point is highlighted in GAD's own representations:

"It was generally accepted in the life insurance market that past levels of terminal bonus did not create reasonable expectations for the future, as they would be entirely dependent on market conditions, subject to a degree of smoothing, which varied considerably from company to company."

The reasonable expectation would not be that the precise policy value quoted would be payable, regardless of market conditions or smoothing, but that any reduction would reflect adverse market conditions. A position where the Society could not afford to honour the policy values without rising market values or inter-generational

transfers would not have been understood by the Society's policyholders on the information provided to them, and would not have informed their reasonable expectations.

The Scrutiny Process

221. The scrutiny system was slow, and its results emerged late relative to periods under review. As a result one scrutiny was frequently overtaken by the next, and outstanding points of criticism or challenge raised in the earlier process were departed from either because they had been dealt with differently in the next returns, or because they had been overlooked in the context of the new returns. Successive GAD actuaries did identify relevant issues, but consistently these were not followed through and were allowed to evaporate. No problem was considered so serious that it could not be left until next time.

222. The service level agreement signed between HMT and FSA on 18 December 1998 set out the nature and scope of duties incumbent on regulators for the effective performance of the duties imposed, and exercise of the powers conferred by, Parliament. Although the 1998 service level agreement was set in the context of FSA's planned statutory objectives and operational aspirations, the delegation by HMT drew on the 1982 Act for the duties and powers contracted out. During the transitional period to N2, there was no wider statutory authority. It has been represented to me that the 1998 agreement reflected considerable regulatory developments since its 1995 predecessor, but it is difficult to see that apart from resources limitations and departmental policy considerations, the regulatory duties would not have had similar scope before the agreement took effect.

223. It has been represented to me that the scrutiny timetable was constrained by primary legislation. The Insurance Companies Act 1982 allowed six months for lodging annual returns. Most companies had the same accounting date. There was necessarily a prioritising of business, involving an initial scrutiny followed by detailed examination on a selective basis according to need. Delay was inevitable. It has been said that it was an unavoidable feature of this system that by the time the earliest scrutinies were completed the information in then was relatively out-of-date as a natural consequence of the legislation. Meantime, market conditions would have moved on, and that might have accounted for at least some of the failures to follow up particular issues that I have identified for critical comment. This defence eloquently highlights the limitations of the system.

Personality Issues

224. The legislation required notification to the regulators of appointments of directors and managers, and required approval for appointment of a new chief executive, managing director or other controller. Appointment could be opposed on the ground that the nominee was not a fit and proper person to hold the office, and (from 1994) on grounds relating to ensuring the sound and prudent management of the office. These provisions implied a responsibility to assess the capacity of those proposed for office as directors and managers. I consider that the Board of the Society failed adequately to ensure the appointment of non-executive directors with the range of skills necessary to procure informed challenge of executive management in relation to the actuarial operations of the Society. The regulatory files inspected by the inquiry suggest that little or no consideration was given to this aspect of the supervisory role, either routinely or at particular junctures, throughout the period for which records are available.

225. In relation to the chief executive for most of the relevant period, Ranson, regulators accepted a situation in which he came to hold simultaneously the offices of chief executive and appointed actuary, at a time when he was also reporting actuary for the purposes of the Society's Companies Act accounts. With few exceptions, he was, until a late stage, the only officer of the Society to meet regulators or GAD, and he acknowledged in discussions with regulators and GAD that he ran the Society in an autocratic manner. Despite the obvious dangers

inherent in such a concentration of authority and influence, and the lack of any qualified challenge within the Society, and officials' clear understanding of the unsatisfactory aspects of the situation, no steps were taken effectively to prevent it from coming about.

226. When in March 1991 the Society intimated that Ranson, already appointed actuary, would succeed Sherlock as chief executive, the Government Actuary, Chris Daykin, wanted to avoid the situation and Ranson was informed. Correspondence ensued in which a temporary expedient was set out. When DTI intimated that Ranson's appointment would be accepted on a temporary basis, he protested that the condition challenged his status as a 'fit an proper person' to hold the office. Within GAD, Daykin had stated that in such an event he would speak to Ranson.

227. Pickford of GAD and Ranson discussed the question on 6 June 1991 at an Institute of Actuaries function, and Pickford intervened. He supported Ranson's view that a point of principle was involved, and on 17 June the condition was removed. Ranson's appointment was confirmed, and his position was thereafter unassailable. The joint holding of these offices resulted in a lack of internal challenge of the actuarial management of the Society and a greater potential for conflict of interest, and increased the responsibility of the regulators to check independently and objectively the validity of the assumptions underlying the calculation of mathematical reserves, implicit items and PRE. However, challenge was ineffective. Ranson was frequently aggressive in his dealings with regulators. He was dismissive of regulators' views and concerns. He was obstructive of scrutiny, and often failed to answer questions put to him.

228. The characterisation of the regulators' and GAD response to Ranson is very much a matter of impression. It has been represented to me that response reflected the civil and measured tones of official correspondence, and that in fact there was continued and sustained challenge of Ranson. That is not my impression. There was challenge, but it was ineffective. Unsatisfactory answers were accepted without follow-up. Lines of inquiry were abandoned or postponed in the face of resistance.

Prudential And Conduct Of Business Regulation

229. The two regulatory authorities failed sufficiently to consider the scope of their respective responsibilities and to ensure that adequate provision was made by them respectively to allocate the total burden of supervision so as to meet total need. This was reflected in the failure to make any provision for the scrutiny of post-contract material, either as it affected the renewal and supplement of existing contracts, or as it was reflected (or not) in the valuation of contractual liabilities and the assessment of PRE. Not only did they fail individually to deal with such matters, but they also failed to institute and maintain a system of communication sufficient to ensure that all relevant material was available in their respective areas of interest. Specifically in relation to the Society's business, there was a failure to consider the implications of the predominant policy type: recurrent single premiums.

230. In respect of that business there was no valid distinction between the initial contract and the renewal of the contract by succeeding contributions. In terms of conduct of business regulation, each transaction was a relevant transaction and, in the case of prudential supervision, repeat contributions were not a contractual right of the Society, and should not have been treated as such for either regulatory purpose. Regardless of the merits of restricting conduct of business regulation to the point of sale, it was not valid for either regulator to regard further contributions as adequately covered by the requirements imposed in respect of the original sale.

231. A practical example of the consequences of the lack of co-ordination was the failure properly to address PRE in the autumn of 1999.

Decision not to Close or Restrict Sales or Advertising

232. Following the House of Lords' decision, when considering whether the Society should close, regulators were faced with competing interests. It is a legitimate and

necessary part of prudential regulation that the interests of existing and potential policyholders may need to be balanced, and I do not find fault with the regulators for arriving at the conclusion that they did, although I am concerned that FSA and GAD did not have sufficient independent knowledge and understanding of the Society's business to justify their confidence that a sale could be achieved. Nor do I consider that the decision reflected a conflict between prudential and conduct of business objectives, a suggestion that is based on a misunderstanding of the nature of prudential regulation.

233. However, the regulators proceeded on an assumption that if anyone were disadvantaged by a decision not to close the Society, compensation would be available. No legal assurance was sought that this would be so, and there was no examination of the legal issues involved. There was no recognition recorded that if compensation claims were sustained, those claims would be at the expense of the with profits fund, nor any attempt to quantify the risks to which potential policyholders were exposed relative to the benefit claimed by management for continuing to trade. No consideration was given to measures that might have mitigated the potential for subsequent claims of misrepresentation. The Society was permitted to continue its advertising, and so those taking new or further policies with the Society did so by invitation and not as mere volunteers without the risks of doing so being made known to them.

234. In the course of maxwellisation it has been represented that criticism of regulators' actions and decisions relating to product sales fails to give adequate weight to FSA's power to require a scheme under which affected policyholders would be compensated without need for litigation. This misses the point that steps could have been taken to protect late joiners in advance. The Society required them to disclaim any potential benefit from the sale of the business. A reasonable counterpart would have been to have protected them from loss by allowing an option to transfer out without penalty in the event of the sale process failing. Thought for the cohort at risk would have identified the need for protection rather than ex post facto compensation.

Annuity Guarantees and the Differential Terminal Bonus Policy

235. The Society's view of their annuity guarantee obligations was intimated to regulators and GAD in general terms in November 1993. The record of that meeting should have informed the scrutiny process thereafter. I do not accept GAD's representations that the record of that meeting did not give a sufficiently clear indication of the Society's intentions to warrant immediate follow-up. The terms in which it was recorded in the note of the meeting make clear that it was intended that guarantees were to be met through some form of trade-off or post hoc charging. At the very least clarification should have been sought. Failure to follow up on the information provided immediately, and more particularly in the context of the scrutiny of the 1993 returns, constituted a serious lapse in regulation. GAD's observation that the record of the meeting suggests that the Society materially under-stated their exposure only makes this failure more pertinent. Any reasonably diligent enquiry would have elicited information about the December 1993 Board resolution, and the terms of the bonus declaration of February 1994, that would have informed GAD and regulators of the problem before it became a disaster for the Society and its policyholders. The regulators' observations to the inquiry, suggesting that annuity guarantees were a conduct of business issue, might explain, though not justify, DTI indifference to the issue. But GAD should still have identified the point.

236. GAD also failed to respond to disclosures of the differential terminal bonus policy in the 1993 and later returns. Failure to make relevant enquiries meant that the regulators and GAD also failed to identify and question the adequacy of disclosure of the policy in statements to policyholders in and after 1995. I note GAD's representations that the disclosures in the returns were convoluted and unclear, and hidden away in many pages of bonus description, and that the service

level agreement did not provide for GAD proactively to pursue bonus policy issues with companies. I do not find them persuasive. It was GAD's responsibility to submit the returns to scrutiny, and to raise issues with the regulators where they were not permitted to pursue them directly with the Society.

Reliance on external assessments

237. DTI paid excessive attention to external ratings, such as by Standard & Poor's, without enquiring into the basis of the assessment, the relevance of the tests applied, and the relevance of the results to the scrutiny of the Society's position.

238. Senior regulatory officers in responding to the maxwellisation process have protested that this assessment is "simply incorrect". They have stated that at the beginning of the 1990s DTI and GAD paid no attention to the assessments of rating agents, in a culture that was relatively inward-looking. In the 1990s staff were encouraged to look to external sources. The representations stated:

"Some staff members may have implied a greater reliance on these ratings in their notes but this was neither policy nor widespread. A significant divergence between in-house assessments and rating agency assessments, or a sharp shift in rating agency assessments, provided a trigger for debate and discussion from time to time. But in general, the view taken was that the ratings agency assessments were relatively superficial; and that changes in rating tended to occur relatively late in the day, and later than shifts in DTI/GAD's own assessments of companies. The existence of rating agency assessments was of course of some use from time to time in dealing with enquiries about the financial strength of life insurers, since the DTI had a clear policy that in-house assessments were not to be revealed; this could conceivably be the cause of the Inquiry's misapprehension."

In my view there is ample evidence to support my original assessment that undue reliance was placed on these sources.

Growth and success.

239. GAD erred in equating the Society's growth in premium income with success. In their representations, GAD have said that it was appropriate for the scrutiny reports to have mentioned new business growth as a positive factor, but they deny that they equated it with success. They say that rapid growth of recurrent business would have rung alarm bells because of new business strain on a company's free assets, but that this was not the case with the Society' because its business was predominantly RSP. This underscores the failure to comprehend the way in which new business costs were treated by the Society, as well as the significance of the Society's famously low free asset ratio. The notion that there was no new business strain with RSP business is misconceived, and the quasi-zillmer adjustment demonstrates the significance of the issue for the Society.

Key Findings

240. The following may be regarded as the key conclusions arising from this report:

- (1) The executive management of the Society resolved as early as 1983 on the approach to meeting the cost of annuity guarantees from terminal bonus that became the differential terminal bonus policy and formed the basis for the *Hyman* litigation. This decision was not communicated to the Board until 1993, and not to policyholders in any form until 1995.
- (2) This policy was material to the decision not to start a new bonus series in 1988 and to market the new personal pensions as essentially a continuation of the earlier retirement annuity business. This exposed those joining the fund to the potential cost of the guarantees and was not adequately disclosed. The Board appear to have taken the decision not to start a new bonus series without adequate consideration of the relevant factors.

- (3) The Society adopted a policy whereby unguaranteed terminal or final bonus became an increasing proportion of total allocations. This was in line with industry trends, but had the intended effect of reducing over time the share of benefits which required to be reserved for or recognised as liabilities in the Society's statutory accounts and regulatory returns.
- (4) As a consequence of this shift towards terminal bonus, and in the absence of any coherent or consistently applied smoothing policy, the Society began to over-allocate from the late 1980s onwards, with the effect that the realistic financial position (as reported regularly on internal systems and therefore known to the executive management) was progressively weakened, and policy claims progressively withdrew funds in excess of prudently calculated policy values. By the end of 2000, the position reached could only be dealt with by radical re-alignment of policy values, as happened in July 2001.
- (5) The Society's solvency position was bolstered over the period by the consistent (and frequently acknowledged) adoption of the weakest valuation basis, plus a series of particular valuation practices of dubious actuarial merit (the interest rate differential, financial reinsurance and the quasi-zillmer adjustment) and other financial adjustments and supports (increasing reliance on future profits and subordinated debt) that sought to anticipate future returns.
- (6) The Board had insufficient knowledge and skills to provide an effective challenge to the executive in critical areas, in particular in relation to product design and liability valuation. Internal systems were ineffective in ensuring that the Board could form an independent view of the financial position of the Society, and the Board accepted a position whereby the provision of financial and product information was too fragmented for a clear picture to be formed.
- (7) Regulation was based on an over-reliance on the appointed actuary, who in the case of the Society was also the chief executive over the critical period from 1991 to 1997, despite a recognition of the potential for conflict of interest inherent in this position.
- (8) The regulatory returns and measures of solvency applied by the regulators did not keep pace with developments in the industry, in particular the trend towards unguaranteed and unreserved for terminal bonus. Thus regulatory solvency became an increasingly irrelevant measure of the realistic financial position of the Society.
- (9) The significance of policyholders' reasonable expectations under the legislation was understood by the regulators, who had also developed over time a good appreciation of the factors involved. There was, however, no consistent or persistent attempt to establish how PRE should affect the acknowledged liabilities of the Society.
- (10) The regulators also failed to give sufficient consideration to the fact that a number of the various measures used to bolster the Society's solvency position were predicated on the emergence of future surplus. In the case of the reinsurance agreement, it is not clear on what basis the Society was permitted to take the credit against its potential annuity guarantee liability that it did.
- (11) There was a general failure on the part of the regulators and GAD to follow up issues that arose in the course of their regulation of the Society, and to mount effective challenge of the management.

It is also significant to note that at all material times the appointed actuary of the Society was able to claim that the Society's valuation practices were consistent with applicable professional standards, and that the auditors are able to claim that the discharge of their duties met all applicable auditing standards.

CHAPTER 20: LESSONS FOR THE FUTURE

1. The single most important contributor to the situation at the Equitable Life as at the inquiry reference date, in my view, was undoubtedly the underlying financial weakness of the with-profits fund that had developed from the late 1980s onwards. As I have sought to make clear, this weakness was not simply a matter of some slippage between two large aggregate numbers, the incidental result of smoothing practice that dipped too far below a prescribed norm. It was the accumulation of a large number of individual differentials, realised and hidden within the continuing fund, between policy values, as recognised by management and expressed to members, and what might otherwise be seen as a fair share of the underlying assets reflecting the duration of each policy and the returns earned by the fund.
2. By the reference date, a large proportion, certainly more than half, of the excess allocated to individual policy values had been crystallised through maturities and other claims. Outgoing policyholders benefited disproportionately from over-payment, to the direct detriment of the continuing and new members of the fund, which continued with a reduced capital base. Despite the attempt to restore equilibrium in July 2001 on a fund basis, the inherited pattern of differentials as among different generations of policyholders persisted, albeit with lower values, after the reference date. In seeking to learn the lessons for the future, this seems to be to be the crucial starting point.
3. In drawing lessons, I have had regard to the work that FSA has been doing to update its rulebook and to learn the lessons from the Equitable experience. As will be reflected below, this work has sought to anticipate many of the lessons that might be drawn by this inquiry, and it should come as no surprise that it has largely succeeded in that. (It might have been a matter of some concern if it had not.) I have included some notes on the FSA's work in Appendix E.
4. I do not wish to comment on the FSA proposals in detail. These are subject to a process of consultation with which I have no desire to interfere. In the context of this report, the most relevant observations are:
 - (a) that there has been active consideration of many of the problems reflected in the account of Equitable's history, and proposals have been tabled that, after due consultation and implementation, could provide the tools necessary for future regulatory systems that would capture the information and issues at stages at which effective action was possible;

But:

- (b) it is worth emphasising at the outset that however highly specified the tools might be, and however well-adapted to the needs of practical regulation, they will be useless unless the personnel charged with their use have the skills and experience necessary for their effective application.

However, there are some particular issues arising from the FSA proposals that I should like to address as I go through the lessons.

Bonus Distribution and Smoothing

5. The gap between the representation of the Society's financial position in its published financial statements, for regulatory and Companies Act purposes, and its realistic financial position arose in large part from the absence of a coherent and consistently applied policy on bonus distribution and smoothing. The Society's frequently acclaimed principle of full distribution combined with its claim to ensure

a smoothed return seem to have acted as an effective shield against a proper consideration by the regulators of Equitable's approach to bonus distribution.

6. FSA's proposals for life offices to provide statements of their principles and practices of financial management (PPFMs) are an important step forward in this respect, as are the FSA's latest proposals on treating with-profits policyholders fairly¹, which were published shortly before this report was finalised. Under these latter proposals there are to be specific rules and guidance on:

- i. Target ranges for payouts and smoothing;
- ii. Definition of 'asset share' for these purposes;
- iii. The distribution of surplus; and
- iv. Surrender values (including market value adjustments/reductions).

I consider that it is essential for the regulators to have a clear statement of a life office's approach to the financial management of its with-profits fund, and its approach to smoothing returns to policyholders in particular. The absence of such a statement was without doubt a serious impediment to effective regulation of Equitable, one that should not have been tolerated as it was. It is also clearly desirable that some such statement is available to the general public, policyholders and their advisers. I therefore welcome FSA's proposals to require offices to be explicit about the parameters within which their discretion over bonuses will normally be exercised, and the consideration that is being given to supporting this with specific rules and guidance.

7. I also agree that, within any rules or guidelines, some leeway must be recognised to enable offices to deal with particular circumstances that fall outwith the realistic range used for establishing those parameters, and to enable firms, within reasonable bounds, to manage a fund back from an under-funded position.

Heterogeneity of With-Profits Funds

8. Looking back at the development of the Society's products over the past half-century, it seems to me inevitable that the homogeneity of any unitary with-profits fund is bound to be undermined as a life office reacts to changing market conditions and changing product demands. There is no obvious a priori basis for determining when existing funds should be closed and new funds opened. There is always scope for including different bonus classes within a single fund, particularly where one can identify and quantify differences in benefits on an acceptable basis among funds that otherwise share common risks. As indicated in the body of the report, it seems to me that it would have been open to the Society to recognise variations in guarantees as among different classes of business as a basis for differentiating bonus policies in and after 1988. The circumstances in which a new class of business gives rise to differences that cannot be accommodated within an undifferentiated fund becomes a matter of circumstances that can only be identified when it occurs: it will be recognised rather than anticipated.

9. There are other problems. In a widely mixed fund, management policies developed at one stage in the fund's progress may become wholly inappropriate at another. An amalgamation of interests that seemed acceptable at one stage, may become difficult to maintain in the light of emerging circumstances. Inter-generational and inter-cohort adjustments may be required that become difficult to explain to those who appear to be adversely affected. Historically 'discretion' has been relied on as authority to make whatever adjustments the actuary and his board have thought appropriate in the circumstances at the time. But in the nature of things, a discretion that is essentially reactive to circumstances that would have been avoided if they had been foreseen is incapable of prior definition. In an era that must be marked by more open definition of management policies and practices, the boards of life offices may have to become more circumspect in seeking to

¹ Treating With-Profits Policyholders Fairly, FSA consultation document CP 207, 5 December 2003.

accommodate business with potential for conflict of interest within a single with-profits fund. Regulators, obliged to consider whether policyholders are treated fairly, having regard among other things to their reasonable expectations, may have to question the management of mixed funds as the business mix changes.

10. Certainly the Society's single with-profits fund incorporated a very wide range of different types of business: traditional life products, pensions products and pure investment products, domestic and overseas business, and even within policies of the same class there were often widely different types or levels of guarantee. The Society's bonus declaration resolutions ran to many pages of detailed allocations varying in kind and value. The system depended on the exercise of the management's wide undefined discretion and resulted in impenetrable complexity.

Implications for PPFMs

11. This underscores the concern, recognised by FSA in their latest consultation paper², that the twin purposes of PPFMs, to inform the regulator and to inform the public, imply rather different levels of disclosure. While it is right that FSA should seek to ensure some definition of the scope of the discretion to write different classes of business within a single with-profits fund, it suggests PPFMs may need to be relatively complex documents if they are to address adequately the totality of some firms' with-profits business at the level necessary to inform a critical appraisal by the regulators³. I therefore agree that it is essential that there should be a second, less detailed tier of material that is carefully crafted in order to create the necessary public transparency. The precise form, and the question of whether or not that should replace existing documents, such as the with-profits guide, I must leave to FSA and those responding to their consultations.

12. A more specific concern arises from the inter-generational transfer point made in chapter 6 and reiterated in the last chapter. The Society managed its with-profits fund in such a way that there was no adequate mechanism for restoring an acceptable balance between policy values and 'asset shares' (within the bounds of established smoothing policy), while also dealing fairly with the legitimate expectations of different generations of policyholders. Thus the fund could be restored to balance, but only by a disproportionate cut in the policy values for more recent policies which had accrued lower levels of bonus than longer-duration policies. It is unclear from the FSA's documents published so far how it is intended to address the position that existed at Equitable. The scope for inter-generational unfairness needs to be recognised. It should be clearly established how bonuses are allocated, and by what mechanisms any imbalances between policy values and asset shares, and between the guaranteed benefits of different generations of policyholder, can be corrected. Whether this should be part of a firm's PPFM may require further consideration.

Development of New Products and Splitting With-Profits Funds

13. The decision taken by Equitable management around 1983 that in the event of a sustained period of low interest rates the cost of the annuity guarantees could be met from within terminal bonus depended on the extent and exercise of the Society's discretion over terminal bonus. The differential terminal bonus policy subsequently adopted was, of course, ruled to be outwith this discretion in the *Hyman* case. However, the differential terminal bonus policy would not have been needed if the Society had adopted a separate bonus series for the new personal pensions business from 1988. The decision to maintain a single series, and to market the new policies as effectively a continuation of the old RAPs, reflected the intended policy. And, as I have already commented, if the Board were genuinely unaware of the management's intended approach to annuity guarantees, then they do not appear to have

² CP 207, chapter 6.

³ If proposals for the preparation of realistic accounts were to develop along the lines proposed by Dullaway and Neddleman in their paper to the Institute of Actuaries on 24 November 2003, neither the PPFM nor the financial statements reflecting the proposals would be intelligible generally.

adequately considered the implications of the guarantees or their options at that time.

14. As I have noted above, there is no a priori basis for determining when a fund should or should not be split. Nor should the regulator become too involved in the process of developing new products. But there is a need for greater vigilance over the introduction of new products and the development of existing products. In the first instance this vigilance must be applied by management, and I note that in CP 207 FSA have proposed new guidance to with-profits firms concerning their approach to the volume of new business, and a new rule that:

“...firms must not write new business unless, in the reasonable opinion of the governing body, this is on terms that are unlikely to have a material adverse effect on the interests of existing with-profits policyholders”.

15. I think this is a reasonable test to ask firms to apply. But it needs to be supported by effective measures to ensure that boards have access to, and an understanding of, their existing liabilities and the implications of new products. I will return to this below. And FSA must ensure that the reporting requirements for firms are designed to pick up significant changes in the balance of interests of new and existing policyholders within the same fund.

16. I assume that the same test will be applied to proposals to issue subordinated debt. It is important, especially with mutual offices like Equitable, that such proposals are given rigorous scrutiny in light of the particular constitution of the office involved. The emphasis FSA are now placing on understanding the commercial reasoning for ‘financial engineering’ should also be helpful here. Despite the claims of management that the purpose of the subordinated debt was to increase investment freedom, the sums involved suggest that it made no real commercial sense except as an immediate measure to ease regulatory controls.

Amounts payable under with-profits policies

17. There was a fundamental lack of transparency in Equitable’s management of policy payouts from the with-profits fund. If the proposals discussed in chapter 4 of CP 207 had been in force, Equitable’s practices would have been exposed to critical appraisal. The suggested requirement that over the longer term average payouts would reflect a broadly neutral balance of smoothing would not have been met at any time from 1987 onwards.

18. However, the proposals lack definition and as currently framed appear to leave unanswered many of the issues that would inevitably have arisen in the Society’s case. The Society would have had no quarrel with the definition of unsmoothed asset share as the value derived from investing the policyholder’s premiums⁴. It would, on the evidence, probably have defined the smoothing cycle prospectively as three to five years. There would have been difficulty in identifying target ranges for payouts and smoothing. But the more substantial issue would have related to the regulatory response to the inevitable failure of the Society to meet its targets. For example, by 1989, and despite the excellent returns of that year, the Society’s payouts were made on the basis of policy values that had exceeded available with-profits assets since at least 1987. In 1990 payouts ignored the dramatic equity losses sustained, and continued to reflect accrued terminal bonus allocations that had ceased to be covered by the investment gains on which they had been computed. Equitable’s methodology simply did not fit the model by reference to which the FSA proposals have been developed.

19. FSA comment that their proposals are “expressed in terms of an objective rather than an obligation”⁵, and in general it is understandable that such an approach should have been adopted. But the Equitable experience suggests that there may be circumstances in which nothing other than an enforceable obligation

⁴ CP 207, paragraph 3.6.

⁵ CP 207, paragraph 4.14.

will empower effective regulatory action. Equitable's methodology may have been uncommon, even unique. But it was widely advertised, and was allowed to continue without disciplinary action by the relevant actuarial bodies. It must be assumed that it was within the scope of acceptable actuarial practice in the profession's view. If so, it could happen again. The present proposals do not equip the regulator to take effective action in such circumstances.

Free Estates

20. I note that FSA's proposed rules on the distribution of surplus seek to address the risk that policyholders may be underpaid over time (building up unnecessary reserves), as well as the risk that they might be overpaid (weakening the fund). While the risk of "excess inherited estates" seems remote from the lessons of this report, based on Equitable's more recent experience, this does highlight the essential question of what constitutes an adequate estate. I welcome the recognition that inter-generational issues should be of significance to the regulator, but FSA must approach this question with caution. It should be clear from the Equitable experience that the need for an estate must reflect the volume, the range and the nature of the business conducted by the life office, and FSA's proposals for realistic accounting (see below), risk-based regulation and individual capital adequacy standards should provide a better means for assessing this than has been available in the past.

21. However, it is also clear to me that the regulator has in the past approached the question of PRE with a strong emphasis on the problem of orphan estates. I would be concerned if that led to a bias against the prudent holding of sufficient risk capital to ensure the office's ability to withstand market and other shocks. This area has been bedevilled in the past by the use of emotive terminology. It will be necessary to provide clear definitions of the several elements of value involved and to require specification of the levels of discretion claimed in respect of each. For example, in the context of reattribution, FSA comment that normally a significant part of the estate would continue to be needed as capital to support the business and neither the policyholders nor the shareholders of the firm would have access to that part of the firm's funds⁶. It seems to me to be clear that one would require specification of all prior calls on the fund, principally liabilities present and future, and operational capital requirements at all times, and not only when a reattribution was in contemplation.

Accounting for With-Profits

22. At no point during the inquiry reference period were Equitable required to account for the financial position of the with-profits fund in terms that would have disclosed a realistic position to policyholders or the regulators. The requirements for disclosure through the Companies Act accounts and the regulatory returns did not require adequate accounting for, or even disclosure of, policyholders' accrued expectations of terminal bonus. Management, however, were aware of the realistic value that might be attached to such expectations, and routinely prepared valuations of the fund on a basis that did recognise this value.

23. Other problems with the Society's published financial statements were the absence of any reconciliation between the accounts and the regulatory returns (or for that matter with the office valuation), valuation movements between accounting dates were not disclosed in an intelligible and informative way, and there were no notes disclosing risks to which the Society was exposed by its approach to liabilities valuation. Furthermore, various financial adjustments were employed, with regulatory sanction, which further removed the stated position from reality. In short, policyholders and the general public were not adequately informed of the Society's

⁶ CP 207, paragraph 5.6

financial position, and the regulator too lacked essential information upon which to form a reasonable view of the Society's realistic financial position going forward.

24. Assuming that one can imagine a future in which with-profits operates in an open way, with published PPFMs constantly monitored and deviations identified and corrected, with smoothing always kept within bounds, and with every policyholder treated fairly, there would remain a need to account for the stewardship of management in published financial statements. The Equitable experience has demonstrated that there has been scope for too many different presentations of financial results, each purporting to present, internally or publicly, a picture of the Society's operations in forms that were difficult if not impossible to reconcile.

25. So long as there is a regulatory solvency test prescribed under European Directives, there will be a need for financial statements that meet the regulatory requirements developed for that purpose. Under the historic regime these statements have been impenetrably mysterious, over-complex, over-wordy, and detailed to the point that overall substantial effect has been buried. The Society's returns were so convoluted that material information escaped notice of regulators and their advisers in GAD. There is a need for regulatory accounts that, however detailed their backing schedules might be, present the results in clear and readily understood form that can be compared with and reconciled with the Companies Act accounts, with differences noted and explained, and information provided as to the reasons giving rise to the differences. Essentially there is a need for an abstract of the regulatory financial statement that can be set against an abstract of the Companies Act accounts and explained.

26. In order that policyholders and members can understand the regulatory picture the objectives of the regulatory accounts need to be specified clearly, positively and negatively. It is important that they should not be presented as providing a measure of the office's overall financial position that cannot be substantiated. Claims that the accounts demonstrated 'solvency', for example, were meaningless without a clear and simple explanation that solvency for this purpose had a highly structured meaning that might have had no bearing on the ability of the insurer to deliver at maturity benefits of the level that might have appeared in illustrations given to the policyholder.

Realistic Accounting

27. The main deficiency in current regulatory accounting has been that the accounts did not reflect the realistic position of the office either in their basic terms, or after financial adjustment for a range of values of a highly technical character that divorced the accounts from the reality of the business. Nor have the Companies Act accounts been much better. They have omitted from technical provisions the value of accrued terminal bonus, and required no other recognition of value reflecting that item. Specifically, where future terminal bonus has been recognised in or related to the fund for future appropriation, there has been no requirement to disclose the office's projection of value of terminal bonus or the extent to which the fund for future appropriation covers that value. Irrespective of how one would quantify accrued terminal bonus, not to recognise it at all is a primary source of the problem in Equitable's case. The Society did not recognise any need to provide for the value, whatever it might have been, and did not allocate any part of its fund for future appropriations to it. Had the Society made clear at any time during the 1990s that there was no accounting recognition of accrued terminal bonus, and that the amount intimated to policyholders was not covered by available assets, the impact on its public image would have been huge.

28. There are other associated problems. The current approach of focusing on the fund position at the accounting date tends to conceal the movements in value that have occurred over the accounting period. Equitable's position in 1990 illustrates the point. The net addition to the fund during the year was £530m. Declared bonus contributed £270m. But there had been premium income alone of over £1.3 billion. Claims had amounted to £660m. On the figures disclosed there was no means of

identifying the movements over the year that explained the relatively low increase in fund value. The president's statement made the bald comment that the liability valuation had been reduced on sound actuarial principles. But that did not provide the basis for analysis.

29. Worse still, there was no information linking the reported annual position and movements in fund value to the position intimated to members in benefits notices. The typical statement issued in February 1991 showed a guaranteed fund value brought forward from the previous year, new investments in the year, guaranteed interest and declared bonus, a new guaranteed fund value at the relevant reference date, and a final bonus addition. There was no adjustment to the guaranteed fund values to reflect the change in valuation assumptions reflected in the accounts. (representing the difference between full or face value versus discounted liabilities) What the Society did, in relation to claims, reflected the position intimated to policyholders in their notices. The accounts did not intimate that despite the actuarial adjustments made at fund level the Society intended to go on paying on claims as if the losses reflected in the reduction in liability values had not occurred.

30. There is a need for accounting standards for the disclosure of movements in value related to actuarial assumptions, for the relationship between accounting information and the quantification of claims payouts generally, and for the publication of accrued terminal bonus values together with a reconciliation between that value and the general reserves available to cover it. The industry cannot be left to its own devices. Without specification of standards, there would continue to be wide scope for differences of opinion that left financial statements substantially meaningless in absolute terms, and difficult to compare with other companies' accounts.

31. I welcome the work that has been undertaken by FSA to develop the role of realistic accounting in the regulatory sphere. This is of particular importance at present, given the absence of adequate accounting standards. The latest SORP, long in gestation, has gone some way towards providing solutions to some of the problems arising from the lack of binding standards. But until there are standards for all financial statements, FSA will have to take the lead in prescribing requirements. The existing limitation of regulatory reporting requirements, in effect, to guaranteed benefits has meant that the reality of with-profits business and the regulatory measure have progressively diverged over a very extended period. This failure to keep the focus up-to-date has been compounded over the years by limitations of the standard principles applied to the valuation of life office liabilities. While the net premium basis applied for regulatory purposes was not well adapted for a firm with significant RSP business, the alternative gross premium or bonus reserve method, to which the Society primarily adhered, was highly subjective.

32. The introduction of FSA's 'twin peaks' approach, under which life offices will be required to set their capital requirements at the higher of the levels brought out on the regulatory solvency and realistic bases, may have to serve as the specification of industry standards for some time. It must be sufficiently robust to fulfil that role.

Financial Adjustments

33. In Part III of this report in particular I have discussed various measures used by the Society to bolster its financial position as measured by the regulator. In this regard I welcome the proposals of the FSA to require firms generally to value guarantees and options at market value, or by means of market-based stochastic techniques. I also welcome the move, recommended in the Baird report, to exercise greater discretion in the use of future profits implicit items. In due course, the changes to the directives will eliminate their use altogether, but in the meantime it is important that the supporting evidence required under the domestic regulations is interpreted as referring to evidence that management expect the returns to emerge from written business on the basis of reasonable assumptions about the future position of the fund.

34. As this inquiry has progressed, I have become increasingly conscious of an aspect of actuarial practice that underlies many of the accounting issues that have arisen: the focus on the present position of the with-profits fund at the given reference date. I have mentioned above one consequence: a disregard of the historical development of the current position, facilitating what I have referred to elsewhere as sweeping the actuarial footprints from the snow. The approach to the judgmental aspects of the future profits item, at least in Equitable's case, tended similarly to focus on the current position, with inadequate attention to anticipated trading conditions looking forward. The issue was treated as relating solely to the existence of current valuation margins, without consideration of the factors that might have a bearing on whether those margins would be likely to be realised as profit in the foreseeable circumstances.

35. The broadening of the discussion of guarantees and options, and of the discretionary element in dealing with future profits are steps that are consistent with the more general move to use realistic accounting and adoption of a more risk-based approach to regulation. These moves should also be helpful in addressing the lessons arising from the financial reinsurance agreement. There is no scope for absolutes here, as FSA recognise, but particular arrangements must be subjected to effective critical appraisal. One relatively simple test might be to compare the claimed value of the protection with its commercial cost. Reinsurance is a commercial business, and providing something of value for nothing or for a very small consideration will be rare. Where a firm claims to have obtained valuable cover for a relatively small premium, the regulator should be wary.

36. I would also draw attention to the claims of particular regulators that they understood the nature of the agreement, that it was essentially a financing instrument that did not purport to transfer risk. Despite that, the treaty was used to offset real liabilities on the regulatory balance sheet. As I have observed earlier, I cannot reconcile that treatment with the requirements of the regulations. The integration of the actuarial and more general regulatory functions under FSA has, in my view, been a necessary and valuable development. Bringing together the various skills involved could only be of advantage as compared with the previous fragmented regime. But I would encourage further development of the multi-disciplinary approach. Consideration of the accounting and legal issues that inevitably arise in the regulatory process should be fully integrated into the primary process. There is a tendency to refer issues for legal advice once they have been focussed in more general discussion. One has the impression that actuaries have at times acted as if they were fully qualified in accountancy, law and other disciplines so as to need no outside support⁷. Whether that is tolerable in a particular company is a matter for that body. It cannot be acceptable in regulation.

37. I particularly welcome FSA's commitment to ensure an enhanced level of testing and assessment for financial engineering generally, including a greater emphasis on the need to address the whole transaction (side letters and all), plus better training for supervisors and more use of specialist expertise, provided that it is recognised that the range of specialist advice that is appropriate may be wide

Common Accounting Base

38. In the longer term it should be an objective to move in due course to use of a common accounting base for all financial statements. Completely independent systems for Companies Act and regulatory financial statements is an unnecessary and confusing complication in what is inherently a difficult area of accounting. Superficially, there is an obvious solution, to base regulatory returns on the Companies Act accounts with a statement of differences linking the two statements.

⁷ One senior actuary told me that he had written contracts in which he incorporated a statement that neither the contract document nor the articles of association of the company set out the whole terms of the contract. It was not immediately obvious to him that he had demonstrated his lack of capacity for the task.

Using the audited accounts as a base would underline directors' responsibilities for the whole financial statements, and with the support of the auditors' report and appropriate actuarial certification of liabilities, enable regulators to concentrate on those aspects of the total statement that had particular relevance. This would make FSA's risk-based regulation more effective. There may be difficulties with this approach, as with any other, and it is necessary to be cautious in proposing solutions that rely on the philosopher's stone. But some such solution would appear to provide a way forward.

39. However, at present the fundamental problem with the statutory accounts of any life office is that the accounting professions have failed to develop acceptable standards for the preparation and presentation of accounts of long-term business that require realistic accounting on a consistent basis, with disclosure of variations in practice reconciling year-on-year results. Proposals, exposure drafts, and similar consultation exercises are not a substitute for normative standards. The continuing failure to produce acceptable standards and secure their implementation is a failure in a professional duty owed to the public. It is a failure in duty to shareholders in proprietary companies. It is a failure in duty to policyholders in proprietary and mutual companies. Those with the responsibility to produce appropriate standards must have it impressed on them that what is required are practical standards of general application that will provide consumers of accounting information and their advisers with ready means of assessing the financial positions of the providers of financial products. A search for perfection in this area will fail. To await agreement among the wide range of interests affected will involve interminable delay.

40. In the case of long-term insurance products, developments focused exclusively on the interests of shareholders will not suffice. Policyholders' interests must be included. Policyholders are investors in offices' products. Their interests, in financial terms, usually exceed those of shareholders by factors of about 9:1. It would be totally unacceptable if standards should be developed that did not focus on the interests of policyholders.

41. If the professions will not or cannot provide necessary standards, domestically or internationally, and FSA's contribution to domestic accounting requirements remains, of necessity, an aspect of regulatory practice, the alternatives would appear to be to accept further stagnation, or for the Government to consider establishing a statutory body with power to impose standards within the UK. This would be a controversial and difficult step. But literally millions of savers are involved, and their interests should prevail over the entrenched privileges of the professions and the interests of the providers. There is a view that with-profits cannot survive without mystery. But that cannot continue to provide an excuse for delay in the open provision of relevant financial information.

Keeping Abreast of the Market

42. More generally, the failure to recognise accrued terminal bonus highlights the need to ensure that regulatory systems are at all times adapted to current practices in the industry. It has been a major theme of this report that prudential regulation remained focused on contractual or guaranteed liabilities, while the industry progressively developed practices that took advantage of the freedom from risk of regulatory intervention in the management of non-guaranteed benefits. There was real dislocation of regulation from the reality of industry practice.

43. It is inevitable that industry practices and product design will change over time, and also that regulated entities may adapt their practices specifically to exploit the characteristics of the regulatory system. That is an inherent, and desirable, aspect of an active market, and the regulators should be careful not to become too prescriptive. But the regulators must keep abreast of market developments, and consider the requirements of the regulatory accounting system against market

trends, and should where necessary require firms to inform policyholders and potential policyholders of the regulatory implications of their practices.

44. The 2000 Act has provided the Treasury and FSA with broadly defined powers to be exercised in light of specified regulatory objectives. This suggests a clear intent on the part of Parliament that the focus for regulation, and the tools employed, should develop with the market. It will not be adequate in future to claim that adhering to a particular practice reflects the will of Ministers long since left office. Constant review will be required to ensure that reporting requirements continue to focus on areas of current relevance to the exercise of regulatory powers.

Audit

45. Audit depends on the adoption of accounting standards. Without the latter there is no point of reference for the audit opinion. However, the issue that arises from Equitable's case, so far as the remit covered this issue, is the inter-action of audit and actuarial verification of underlying assumptions in the liabilities valuation. In the case of the Society, the audit team were aware of relationships between assets on the one hand, and liabilities and future payments of terminal bonus reflected in the bonus notices to policyholders on the other. But there was no need to advertise the differences because of the view taken that final bonus was not 'guaranteed'. This left the Companies Act accounts less than informative of the real position of the Society as it affected not just policyholders as a whole, but different generations and different cohorts of policyholders.

46. The omission from the scope of auditors' responsibilities, over considerable periods, of a duty to report on the actuarial assumptions on which the liabilities themselves were determined, as distinct from taking steps to satisfy themselves that they could rely on the reporting actuary, was a weakness in the system that required and still requires to be addressed. Evidence of this weakness can be seen in the Society's failure to value its primary obligations with respect to its annuity guarantees and options appropriately.

47. The basic problem here is that an audit of part of a balance sheet cannot provide comfort in relation to the state of affairs of the company in question generally. The exclusion of the auditor from responsibility for liability valuation in the early 1970s should never have been contemplated, in my view, and it should not be allowed to continue. The contemporary debate reflected a degree of arrogant professional discrimination against the accounting profession, especially on the part of GAD, that was and should have been seen to have been, wholly unacceptable. In the result, one had an audit that was less than comprehensive. Of its nature a 'balance' sheet only makes sense, even assuming it is aimed at presenting the realistic position of the entity, if the policies and practices adopted in computing and expressing assets and liabilities are compatible. Allowing one professional, the auditor, to express a view about the assets and peripheral liabilities, but excluding him from the long-term liabilities, while allowing another professional, the actuary, independently to certify the liabilities is like commissioning the two legs of a pair of trousers from separate tailors.

48. I note that FSA have proposed a requirement for the auditor to obtain a report from an independent actuary. That is a material improvement in the position, and it is to be welcomed. It should ensure that the audit opinion is supported, in relation to the technical provisions of the long-term business, by a qualified expert's opinion on the actuarial issues that arise from the valuation. In that respect, the audit of long-term business would be in line with other sectors where the auditor is necessarily dependent on third party professional opinion.

49. The question, however, is whether one should go further. The valuation of a life office's liabilities, and of any additional provisions that might be required for accrued terminal bonus, for example, are so fundamental to any assessment of the company's financial position that, if audit cannot be comprehensive, there is a case

for a direct report to shareholders and policyholders by an actuary, on the face of the accounts and in parallel with the audit report. The report would require to express opinions on the valuation and on the essential assumptions reflected in it similar to those contained in the auditor's report, and the actuary would be responsible for his opinions as the auditor now is for his. Ideally, since the two reports would be complementary, there would be a case for legislation to make provision for a joint opinion of an auditor and an independent actuary, for which they would be jointly and severally liable, that the accounts met the specified standards. That would reflect the reality that it was the cumulative effect of the two reports, and that alone, that provided the necessary support of the financial statement. But I have come to the view that that would be a step too far at this stage, before the more limited proposals have been implemented and tried in practice.

Corporate Governance

50. Arguably the first and most significant failure identified in this report lay at the heart of the Society. The critical responsibilities for valuing liabilities, assessing the liability implications of new products, and identifying and monitoring risk generally were discharged by a discrete part of the organisation that was not subject to effective scrutiny or challenge. The Board at no stage got fully to grips with the financial situation faced by the Society: information was too fragmented, their collective skills were inadequate for the task, and there were no effective arrangements for ensuring that there was detailed examination of, and onward reporting to the Board on, actuarial reports. Equitable's non-executive directors were so wholly dependent on actuarial input from the executive and in particular from the chief executive/actuary that they were largely incapable of exercising any influence on the actuarial management of the Society.

51. In the case of proprietary firms, the primary responsibility for the selection of directors and calling the board to account for its direction of the business must continue to rest with the shareholders of the company, whose capital stands at risk in the event of mis-management. However, the position is different for a mutual like Equitable, where it is the policyholders who are the source of the risk capital for the enterprise. This raises particular issues in relation to the constitution of the Society. Under the Society's articles policyholders were effectively powerless, and the Board was a self-perpetuating oligarchy amenable to policyholder pressure only at its discretion. It is impossible in practice for policyholders to initiate by requisition an EGM or otherwise to raise special business. Board appointments are effectively in the hands of the current Board.

52. Since 1994 the regulator has had a responsibility to assess whether life offices are soundly and prudently managed. This clearly implies a holistic assessment of the firm and its board that goes beyond the individual assessment of whether individual directors were 'fit and proper'. This broader responsibility has been carried forward into the new regulatory regime, and is reflected in FSA's proposals for risk-based regulation and individual capital adequacy standards. However, it is important that FSA consider how their powers may be exercised to address the problem of unbalanced or ineffective boards. The approved persons regime under the 2000 Act, like the fit and proper regimes it replaced, is essentially designed to deal with the individual officer rather than the board as a whole. This is a difficult and potentially controversial area, that goes to the heart of the respective responsibilities of the directors and the regulators, but it seems to me essential that the regulators should be confident that where necessary they are able to require changes to the board to address major gaps or imbalances in directors' collective skills or experience.

53. It may be seldom that directors and their representatives will assert as strongly as has been the case during this inquiry that, as generalist non-executive directors, the individuals in question were incapable of addressing independently

such fundamental aspects of the firm's business as actuarial management and liability valuation. But the situation may not be uncommon. Difficult though the exercise may be, there appears to be no alternative means of securing an independent view of the appropriateness of the membership of life offices' boards than the exercise by FSA of powers to refuse approval on grounds that the nominee for appointment would not make a necessary contribution to the sound and prudent management of the office by filling a gap in the range of skills and experience required by the office. In the case of an office like Equitable, it is clear that no other means of ensuring an appropriate range of skills and experience would have been effective.

54. The constitutional position of Equitable may be unusual. Participation in governance by members was impracticable. The articles relied on the current Companies Act provisions, with their requirement to obtain the support of 10% of the voting power to initiate special business, which may be well-enough adapted to organisations with a relatively low membership, but are poorly adapted to any large financial mutual with hundreds of thousands of members and no adequate public register to enable a group of concerned members to requisition business. Other offices, such as Standard Life, now allow a minority by number to requisition business. I see no ready means by which regulators could force the remaining mutuals to adopt articles that facilitated policyholder action, unless it could be brought within the test of 'treating policyholders fairly'. But one way or another, means must be found to give policyholders an effective voice in mutual management. Without that, policyholders' committees and other such devices will not be of substance. It may be that sufficient pressure can be brought through FSA's risk-based approach to regulation to persuade mutual offices to facilitate policyholder participation in governance, but if that cannot be achieved, other means will have to be considered.

55. There would be resistance to direct involvement of regulators in management for understandable reasons. The nominee director has always been a controversial notion. And the regulator would be unlikely to welcome an obligation to participate in management. But it might be acceptable for the regulator to have power to appoint from a panel of experts an adviser to the board of a life office in case of need, with access to all board papers and to the board itself, and with power to report to FSA on management. This would fall short of the formal appointment of an independent reporter. It could be more flexible. And if it failed to produce results FSA's subsequent formal action would be facilitated. A power to report to FSA rather than an obligation would improve the prospects of acceptance of the adviser as a source of support to the board rather than a threat to current management. An occasion for the appointment of such an adviser would be recognition of a risk that the firm might be in danger of failing in its obligation to treat policyholders fairly.

56. The representations I have received, and indeed much of the evidence I have reviewed bearing on the governance of Equitable, point to a need for an authoritative statement of the duties, rights and privileges of directors. In chapter 9 I referred briefly to the work of the Law Commissions, and the Government's Company Law Review and White Paper relating to the nature and extent of directors' duties and responsibilities, including their powers of delegation. If the representation of Equitable's directors were taken as a proper reflection of general views within industry generally, the case for implementation of the recommendations for reform would, I suggest, be overwhelming. It is not necessary to go that far. It is enough that it has been possible for it to be suggested that non-executive directors of a major financial institution should be recognised to have limited responsibilities for the direction of certain aspects of the company's business. On that basis alone there is an obvious need to put in place a statutory framework for the future.

Role of the Actuaries

57. In most cases the existing appointed actuary system has probably performed well, and met the legitimate interests of all concerned. I cannot express any general conclusion. But there must be concern at the reliance that has been placed in the past on an office that could encompass such extremes in terms of experience and authority within life offices. At one end of the spectrum, the system could accommodate an idiosyncratic and autocratic individual, like Roy Ranson, charged with running large with-profits funds without significant control by his colleagues, his board, the auditor or the regulator. At the other end of the spectrum there is the minor technician, wholly subordinate to senior management and a board to which he may have but occasional access, and over which he has little influence.

58. Clearly, every life office must have actuarial staff. Should the existing appointed actuary system continue, it is clear that on no account should it be permitted that the appointed actuary should also be the chief executive. That combination should simply be banned under the approved persons regime. It undermines fundamentally the 'whistle-blowing' obligations of the appointed actuary, and would similarly affect any substitute. And it is also clear that if any external reliance is to be placed on the professional opinion of an actuary, in whatever capacity within a life office, the actuarial profession must be encouraged to impose appropriate discipline. Moves to encourage the profession to take that direction in the past have been abandoned by regulators as 'difficult'. But if the profession does not wish to be judged by the lowest common denominator: (a) it must have a well-developed set of prescribed standards; and (b) it must have a properly developed disciplinary procedural system to confront deviant conduct.

59. So far as the disciplinary structure is concerned, the professional bodies in Scotland and in England have radically overhauled their disciplinary structures and, uniquely, have taken steps to ensure the independence of those engaged in disciplinary work by providing for the selection and nomination of candidates by an independent committee chaired by a lawyer with considerable experience in professional disciplinary matters. But there is one area in which I consider there are further steps that could be taken with advantage.

60. In the past disciplinary procedures have typically been reactive to complaints. I have suggested, and repeat the suggestion for consideration, that that does not meet the need in the case of long-term business. In most professional business there is a clearly defined relationship with an identified client. A solicitor or accountant may have a stock answer to a problem that he provides to a series of clients, as a general practitioner will have preferred prescriptions for the treatment of recurring symptoms. But in each case there is a direct contact, and a context for assessing the appropriateness of the advice. The with-profits actuary to a life office serves a huge constituency. Most members of that constituency will have little or no independent understanding of the characteristics of the product under current rules, and while that will improve in future there will be limits to policyholders' knowledge and understanding of long-term products for some time. Education is not instantaneous. The policyholder, unlike the patient, will have a poor understanding at best of the facts and circumstances that might need attention. Few of Equitable's policyholders would have understood the implications of the differential terminal bonus policy without the help of the action groups. It is not enough for the actuarial profession to await complaints. The people best placed to identify the need for disciplinary intervention are co-professionals. It would improve the public image of the profession if it were seen to accept responsibility for direct intervention where it was thought that the administration of life funds was likely to threaten the legitimate interests of policyholders. I would invite ministers to offer encouragement and support for initiatives that the profession might take in this direction.

61. Whether the existing appointed actuary system should continue, or whether FSA's current proposals for a 'with-profits actuary' offer any greater prospect of

effective discipline on the internal actuarial management of life offices, are matters open to argument. In my view, the precise arrangements are less important than the solution to the problem of independent and effective actuarial 'audit'. Audit procedures that ensured independent verification of the validity of the actuarial assumptions on which the valuation is based, squarely focused on the public interest comprising the interests of shareholders and policyholders, and the duty to treat policyholders fairly, including with regard to PRE (a phrase that, however clumsy, appears to have a place in the new order), and the provision of a realistic balance sheet would go far to reduce the importance of the internal organisation of the actuarial management of the office.

62. If effective audit can be achieved, this will greatly facilitate effective regulation. Without it, the task of the regulator will have to be that much more intrusive into the detailed actuarial affairs of the life offices they seek to regulate.

63. In the course of the report I have commented on what I have found to be deficiencies in the specification of standards of practice. I have commented on the lack of standards relating to managing policyholders' reasonable expectations. That will carry forward into the new regime with respect to the obligation to treat policyholders fairly, including with respect to PRE. I have referred to the failure to promulgate appropriate standards for valuing guarantees. The joint professions have set up a committee to consider the elaboration of standards for future professional practice. They should be encouraged in this task.

Conduct of Business Regulation

64. One of the regulators involved with Equitable referred to the boundary between prudential and conduct of business regulation as more an awkwardness than a lacuna. While that may be a fair comment on how the two branches were intended to operate, in practice the lack of co-ordination of prudential and conduct of business regulation in relation to the Society was unacceptable. The Society's changes of policy forms and of the guarantees provided is a typical area where there was a role for each regulator. The conduct of business team were no doubt interested to ensure that the prospectus met the requirements of the disclosure. There may be questions whether the risks were adequately focused in the Society's literature in any event. But the risks could not have been assessed by the conduct of business regulator without reference to the prudential regulator. Had this happened, it might have focussed attention on the implications of the low free asset ratio for new policyholders.

65. The prudential regulator for his part should have been concerned about the impact of the reduction of guarantees on reserving, given the low level of free reserves Equitable had. But that could not be done without undertaking more routine analysis of the product terms, which was clearly regarded as the province of the conduct of business regulator. And the prudential regulator might have been influenced by learning how hard a sell there was of the newer, more 'technically efficient' products. Each exercise should have been instructed by comparing analyses, ideas and notes.

66. The conduct of business regulators adopted a narrow approach to the 'point of sale' that reflected misunderstanding of the contracts the Society sold. In particular, there seems to have been at best a poor appreciation of the peculiar characteristics of the RSP contract. Conduct of business regulators treated the business as if it were all pre-A day because, in most cases, the original contract was so dated. Since the policyholder had a right, but no obligation, to subscribe further sums, each successive contribution required a fresh transaction, and a fresh assessment of the appropriateness of the contract for the policyholder's need. Again co-ordination with the prudential regulators should have alerted them to the peculiarities of the form and the need to look on each successive year as a new transaction.

67. With the introduction of the single regulator and the reorganisation of responsibilities within the FSA, the resolution of this problem is in hand. It is vital that FSA continue to work towards a more holistic approach to the business of particular firms and groups. To avoid further awkwardness, care of the customer must be extended throughout the life of the contract without artificial barriers. And the understanding of product ranges, which should be gained through conduct of business regulation, must be used to inform the financial side of supervision.

Clarifying Regulatory Objectives

68. Clarity about the regulatory objective is a difficult issue. The representations received by the inquiry from individual policyholders and from their representative groups, along with media coverage of the response to the situation of Equitable, have reflected intense disappointment in the performance of the regulatory system generally. There is a significant gap between the public's expectations of regulation and what people believe has been delivered in this instance. There is a lack of trust in regulators that has transmitted to FSA as if that organisation were in every respect the successor to the now superseded regimes that were in operation down to N2.

69. In this report I have been critical of the regulatory system, and on occasion critical of the performance of regulators and their advisers. But the thrust of my criticism is that for the most part it was the system that failed to provide the regulation that changing circumstances in the industry required, not that there was failure to implement what was fundamentally a satisfactory system.

70. A major lesson to be learnt from the Equitable saga must be that the consumer of financial products should be informed, clearly and succinctly, of the scope of regulation and what can be expected of it. I understand and accept why no regulatory regime can seek to deliver zero failures. The cost of such a system for consumers and providers alike would be disproportionate, and by appearing to insulate consumers entirely from the risk inherent in the selection of an investment product such an approach could give rise to perverse economic incentives for both consumers and providers. However, it is equally clear that building false expectations of regulators can lead to a destruction of public confidence when, as may well be inevitable, a failure such as this one occurs. The responsibility for ensuring that consumers and potential consumers are informed of the objectives of regulation, and of the limitations inherent in those objectives lies with the regulator, and it is a responsibility owed to the consumer.

71. I do not underestimate the difficulty of this task. This is an especially complex area of a complex industry. Many consumers and potential consumers of life products may be ill-equipped to assess the suitability of the products on sale without assistance, and there is no obligation on the consumer to take independent advice. There is an inherent tension between the regulator's responsibilities for the health of the industry and for ensuring that policyholders are treated fairly. Objective quantification of the levels of risk which the system implicitly accepts may prove to be a particularly sensitive or difficult discipline. Nor is it easy to define the role of regulators relative to the directors of the office, or to those providing reports and certificates in support of financial statements.

72. But, effective consumer education is essential. It will not be enough to acknowledge the responsibility to provide necessary education. This is an area in which the regulator must deliver, with or without external support. And the exercise must be kept up to date, reflecting the regulator's response to changing industry practices and the consumer's needs in changing circumstances.

73. Regulators must also take care not to circumscribe their responsibilities in such a way that they create negative expectations: if regulation truly contributed little or nothing to ensuring that policyholders and potential policyholders were treated fairly, for example, it might be better to abandon that aspect of regulation

altogether. That is the clear lesson of the treatment of PRE by DTI in the 1970s and 1980s. The statutory power of intervention generated responsibilities that were not fulfilled, and the reputation of regulation generally was jeopardised.

74. As well as defining clearly the scope of the regulatory function, there is a need, which can perhaps more appropriately be shared with others, to define the scope of individual responsibility. The individual's responsibility for resolving personal issues such as the acceptability of risk with or without the assistance of an independent financial adviser requires particular attention.

75. Reference to insurance companies' financial statements in their current forms would not improve the individual's understanding of the risks and likely benefits associated with the products offered. The typical auditors' report on the Companies Act accounts lacks substance generally, and in any event has its focus in the state of affairs of the office rather than on the characteristics of the products that are relevant to the individual consumer. The appointed actuary is concerned with the health of the fund overall. The published regulatory returns are complex to the point of incomprehensibility: it is clear that Equitable's returns were not understood by GAD actuaries throughout the 1990s. The individual may take, but is not obliged to take, independent financial advice. The definition of the regulator's function and of the reliance that can be put on regulation in the circumstances is complicated by the wider context.

76. Informative pamphlets have a role to play. But there is a need for the contract documents to set out in plain terms the obligations of the policyholder to satisfy himself of the suitability of the product for his needs. It is in this context that simple statements forming part of the contract must be developed. A bald statement of the caveat emptor principle would not suffice. FSA's current proposals for statements beyond PPFMs could provide a basis for a requirement that the policyholder should satisfy himself that a product with the characteristics described met his needs within an acceptable range of risks. This could be made, with other forms and declarations, part of the basis of the contract.

Postscript

77. Many readers of this report will be frustrated that it has not provided answers to two questions: who is at fault for the problems encountered by the Society, and who deserves redress as a consequence? It has been no part of this inquiry to attempt to answer either question. The first inevitably involves issues of the scope of duty and of breach of duty that I was not asked to consider and that I would have been unwilling to consider as part of an inquisitorial process. The current proceedings at the instance of the Society speak eloquently of the complexity of the questions that arise from allegations of breach of duty relating to a relatively short period compared to the period covered by the inquiry, and a selection of issues from the wider range that I have discussed. An open adversarial process such as would have been necessary to replicate the litigation process over the longer period and the wider range of issues would have been beyond contemplation.

78. The second issue is also wide, if less so than the first. I invited individual policyholders to assist me by formulating their claims in order to test policyholders' understanding of the issues, and, if possible, to help form a view about the potential liabilities of the Society at the reference date. The information was not in form or substance sufficient to provide an indication of the Society's total exposure, though it made clear that very substantial claims were involved. But it did expose potential problems of entitlement to compensation and quantification of loss, where loss was recoverable, of considerable complexity. In the light of the investigations I have carried out I understand the Society's current attempts to resolve claims on individual bases: there may be no practicable alternative, though I express no view on the particular approach adopted by the Society.

79. I have set out my findings on the evidence I have recovered. The maxwellisation process has made it clear that those findings are not generally acceptable to those targeted for criticism. Some of the representations, carefully crafted by legal advisers, have reflected positions adopted in the current litigation and could hardly have been expected to have been different. But it must be emphasised that the report sets out my findings, reflecting my assessment of the evidence, and not a consensus statement of the position. Any court or other adjudicator resolving issues of duty, or professional conduct, will require to make an independent assessment of the facts, in default of agreement, and that may agree or disagree with the views I have expressed. Policyholders, in particular, must not base their expectations on the report beyond what it offers: my best assessment of the evidence I have recovered.

80. However, whatever the position on compensation might prove to be in the end of the day, it is clear that many Equitable policyholders have suffered much worry and distress, and many have been and will continue to experience real financial hardship, as a result of seeing the returns they had expected from their savings very dramatically reduced. A hard lesson for many has been that it is the nature of a mutual with-profits office that the members have little recourse to anyone other than the other members for recovery of their own losses. I am in no position to make any general finding as to the manner in which this aspect of their investments might or might not have been drawn to their attention: that depends on what they were told individually and what they understood at the time, and it is clear that individual cases differ. But, with few exceptions, those who have suffered have been the innocent victims of this affair. And it is management of the threat to individuals in similar positions that perhaps has to provide the primary motivation towards reform.

81. It is also clear, however, that many past policyholders gained disproportionately from the administration of the fund, over the 1990s in particular. Payouts on claims, in particular on maturities which did not attract financial adjustments and contributed to the excess claims values described in this report, were payments to individual policyholders who had been members of the with-profits fund. Some re-invested in the with-profits fund, and in some cases recent losses and earlier over-payments may have to be off-set against each other for a proper understanding of the financial position. In this case timing differences have resulted in a range of benefits relative to contributions that cannot be rationalised. This should not characterise the management of a with-profits fund.

82. If the Society recovers damages in the current litigation, the sums will accrue to the with-profits fund, and benefit those who remain members of that fund at the appropriate time and other qualifying creditors of the Society. Inevitably the benefit will accrue to a different constituency from that identifiable at any earlier time. Maturities during the litigation process will not benefit from any recoveries any more than earlier maturities. If the Society succeeds in establishing liability, that will have demonstrated fault on the part of some or all of the defendants in some respects that fall within the ambit of the allegations sent to trial. It will perhaps exhaust the scope for claims that have not expired, though it will not resolve all of the issues that might arise on the facts found in this report.

83. As for the regulatory system, I do believe that it has failed policyholders in this case. This is not, in general, because of individual failures. I do not pin that blame on individuals, who in the main have operated in good faith and to the best of their abilities within the system as they found it. But I do take the view that the system itself was not overseen, and in particular was not kept up-to-date, and operated in an ineffective manner.

84. The deficiencies are not so obvious as some are inclined (or wish) to believe. And, it is seldom enough, and it is not enough in this case, to infer from the coincidence of systems deficiencies and loss that one caused or contributed to the other. Principally, the Society was author of its own misfortunes. Regulatory system

failures were secondary factors. The jurisdiction to adjudicate on regulatory failure in duty is not mine. Even less is it for me to comment on how government should respond if it were to acknowledge that there had been regulatory failure. But it may be appropriate to comment that the practices of the Society's management could not have been sustained over a material part of the 1990s had there been in place an appropriate regulatory structure adapted to the requirements of a changing industry that happened to manifest themselves in an extreme form in the case of Equitable Life.