

Return to an Order of the
Honourable the House of Commons dated
16 October 2001 for the

**Report of the Financial Services Authority
on the review of the Regulation of the
Equitable Life Assurance Society
from 1 January 1999 to 8 December 2000,
which Her Majesty's Government
is submitting as Evidence
to the Inquiry Conducted by Lord Penrose**

Ordered by The House of Commons to be printed 16 October 2001

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The attached Report contains references to opinions and advice and their contents obtained by Equitable Life Assurance Society and provided to HMT-ID (subsequently FSA (IFSD)) in the course of normal exchanges between a regulated body and its regulator and for the specific purpose of allowing HMT-ID to fulfil its regulatory functions. It is acknowledged by the FSA that Equitable Life Assurance Society has waived privilege in this material only for that specific purpose and that Equitable Life Assurance Society does not intend any wider or general waiver of privilege by agreeing to the inclusion of the material in this Report, which it is understood will be published.

Abbreviations

1994 Regulations	Insurance Companies Regulations 1994 (as amended)
1996 Regulations	Insurance Companies (Accounts and Statements) Regulations 1996 (as amended)
A day	29 April 1988 - the date on which regulatory regime under the FSAct 1986 came into force
Appointed Actuary	the actuary every life company must appoint in accordance with the ICA 1982
CA 1985	Companies Act 1985
DTI	The Department of Trade and Industry
Enforcement	a department known as Regulatory Enforcement (PIA firms/Bank Investigations) within a separate Enforcement Division of the FSA
Equitable Life	Equitable Life Assurance Society
EST	Economic Secretary to the Treasury
Faculty	Faculty of Actuaries
FIMBRA	Financial Intermediaries Managers and Brokers Regulatory Association
FMC	Firms and Markets Committee
the FSA	The Financial Services Authority
FSAct 1986	Financial Services Act 1986
FSMA 2000	Financial Services and Markets Act 2000
GAD	The Government Actuary's Department
GAD SLA	the service level agreement between the GAD and the DTI (originally, then the Treasury and now the FSA as the prudential regulators) dated 6 November 1998
GAO	Guaranteed Annuity Option
GAO policies	those policies containing an option to take a GAR
GAR	Guaranteed Annuity Rate

GAR policyholder	a policyholder who has the benefit of a GAR
GCD	General Counsel's Division of the FSA
GN1	Guidance Note 1: Actuaries and Long-Term Insurance Business issued by the Institute and Faculty
GN2	Guidance Note 2: Financial Condition Reports issued by the Institute and Faculty
GN8	Guidance Note 8: Additional Guidance for Appointed Actuaries and Appropriate Actuaries issued by the Institute and Faculty
Government Actuary	the head of the GAD
HMT	Her Majesty's Treasury
HMT-ID	the Insurance Directorate at HMT
IBD	the Investment Business Division of the FSA
IB-PIA	the department within IBD responsible for carrying out the functions of the PIA under the PIA SLA
IB-PIA (Advertising)	the specialist team within IB-PIA which monitors advertising by PIA firms
IB-PIA (Supervision)	the specialist team within IB-PIA which provides a support service to IB-PIA (and generally within the FSA) by answering queries about the PIA Rules
IB-Policy	the department within IBD which deals with the policy development issues in relation to the three SROs
ICA 1982	Insurance Companies Act 1982
IERC	Irish European Reinsurance Company
IFA	Independent Financial Adviser
IFSD	Insurance and Friendly Societies Division of the FSA
Inheritance Period	the period prior to the Review Period
Institute	the Institute of Actuaries
ISC	Insurance Supervisory Committee

Lautro	The Life Assurance and Unit Trust Regulatory Organisation
N2	The date on which FSMA 2000 will take full effect
OA-CSP	overall assessment and co-ordinated supervisory programme
PFW	a pension fund withdrawal (also called an income drawdown)
PIA	Personal Investment Authority
PIA Ombudsman	the independent complaints handling agency for resolving complaints by investors against firms which are regulated by PIA
PIA Rules	the rules of the PIA
PIA SLA	the service level agreement between the PIA and FSA dated 28 May 1998
PRE	policyholders' reasonable expectations
Review Period	the period from 1 January 1999 until 8 December 2000
Review Team	Ronnie Baird, Director, Quality Assurance and Internal Audit, Oscar Edridge, a member of his staff, PricewaterhouseCoopers and Norton Rose
RMM	required minimum margin
RMS	required margin of solvency
SIB	Securities and Investments Board
SLA	service level agreement
SRO	self-regulating organisation
TAD	Treasury Advisory Division
Treasury SLA	the service level agreement between HMT and the FSA dated 18 December 1998

Chapter One

Introduction

1.1 Introduction

- 1.1.1 Equitable Life Assurance Society (“**Equitable Life**”) is the world’s oldest mutual life assurance society. It was established as the “Society for Equitable Assurances on Lives and Survivorships” in 1762. Equitable Life has written a mixture of with-profits and non-profits business.
- 1.1.2 On 8 December 2000 the Board of Equitable Life announced that it would stop writing new business with immediate effect. Equitable Life reported that it remained solvent and would continue to pay out benefits and accept premiums under existing policies although investment performance and bonuses were likely to be impaired.
- 1.1.3 This announcement was the culmination of a period of uncertainty following a House of Lords’ judgment delivered on 20 July 2000 in legal proceedings which Equitable Life had commenced in January 1999 to test the lawfulness of a practice it had adopted with respect to the allocation of terminal bonuses amongst policyholders. The financial implications of the judgment of the House of Lords caused Equitable Life to put itself up for sale and, on failing to find a purchaser, the Board announced Equitable Life’s closure to new business.

1.2 Background - the Origins

- 1.2.1 The origin of Equitable Life’s problems related to a guarantee which had been a standard feature in some pension policies written between 1957 and June 1988. This guarantee provided policyholders, at the date of retirement, with the option of obtaining an annuity at a fixed guaranteed rate - a Guaranteed Annuity Rate (“**GAR**”). (This Report will refer to policyholders who had the benefit of a GAR as “GAR policyholders”, and will refer to policies containing a guaranteed annuity option (“**GAO**”) to take a GAR as “**GAO policies**”¹). The other options available to a GAR policyholder included the purchase of an annuity at current annuity rates (which fluctuate in line with interest and mortality rates) either from Equitable Life or from another life insurance company in the open market. Existing GAO policies remained valid after July 1988 and GAR policyholders could continue to contribute by paying additional premiums.
- 1.2.2 During the period when GAO policies were being sold, current annuity rates were consistently higher than the guaranteed rate. However, in late 1993, the position changed when current annuity rates slumped. Despite a brief resurgence in 1994, from mid-1995 the GAR has been consistently higher than current annuity rates. The problem was compounded by the fact that the margin between guaranteed and current rates had been increasing. By September 1998, GARs in policies issued between 1957 and 1988, were approximately 30% higher than current annuity rates.

1.3 The Significance of the GAR to Equitable Life

- 1.3.1 Although GAR business was common throughout the life insurance market, the issue was of particular significance to Equitable Life for two reasons; firstly, because Equitable Life had written 116,000 GAO policies, a much bigger proportion of its business than was the case with other companies; and secondly, because Equitable

¹ Chapter 3 provides a further explanation of the guaranteed annuity provisions. However, it should be noted that practitioners use the acronyms interchangeably. In order to reflect the contents of the relevant documents, we have adopted the acronym used in that document although we recognise that this may lead to inconsistency.

Life's long-standing philosophy was always to provide a full distribution of profits to its policyholders and it had little excess capital over and above the funds necessary to meet its liabilities and satisfy solvency requirements and, as a mutual, it had no shareholder funds on which to draw.

1.4 The Terminal Bonus Practice

- 1.4.1 In 1993, the Board of Equitable Life sought to address the GAR issue in a way which it maintained was consistent with its established approach to distributing surplus. Equitable Life adopted a differential terminal bonus practice which reduced the level of terminal bonus paid to policyholders exercising their GAO, thereby equalising the benefits being taken by GAR policyholders and non-GAR policyholders. The practical effect of this was that the GAR provided GAR policyholders with no discernible additional benefit to those with non-GAR policies. The Board of Equitable Life believed that it was entitled to adopt this practice by exercising a discretion under the Articles of Association of the Society.
- 1.4.2 This practice became the subject of an increasing number of complaints and press attention during late 1998. These complaints were initially dealt with by the Personal Investment Authority Ombudsman ("**PIA Ombudsman**"). However, in December 1998, Equitable Life asked the PIA Ombudsman to relinquish jurisdiction over the complaints to the High Court as it was felt that this would provide the fairest and quickest way of resolving the issue.

1.5 The Court Case

- 1.5.1 In order that the GAR issue and the legality of Equitable Life's terminal bonus practice could be considered by the Court, it was decided that proceedings should be based on the case of one GAR policyholder who would act as a representative for all GAR policyholders, whilst Equitable Life was to represent the interests of the non-GAR policyholders. Mr Alan David Hyman was selected to be the GAR policyholder who would be the representative defendant. The Defendant's case challenged Equitable Life's terminal bonus practice on the grounds that it was in breach of the contractual arrangements which underpinned the guarantee. The case was taken on appeal ultimately to the House of Lords, who declared, unanimously, that the practice was in breach of contract; judicial interpretation of the contract was that it required Equitable Life to pay GAR policyholders the same terminal bonus as had been paid to non-GAR policyholders.

1.6 The Consequences

- 1.6.1 The consequence of the House of Lords' decision was that Equitable Life, without access to any sufficient free capital of its own, either in the form of reserves or shareholder capital, was unable to withstand, in the long-term, the impact of the very substantial and effectively unquantifiable liabilities which arose from the House of Lords' judgment. The Board decided that it had to look to an external source of capital in the form of a buyer of the business in order to enable it to continue to write new business. Immediately following the handing down of the House of Lords' judgment, the Board of Equitable Life announced that Equitable Life was up for sale. It declared that its members' interests would be best served by the sale of the business to an organisation capable of providing capital support, thereby safeguarding long-term investment freedom. By 8 December 2000, however, all potential purchasers had decided not to proceed and, as a consequence, the Board of Equitable Life decided the only prudent course of action was to cease writing new business.
- 1.6.2 As of 8 December 2000, the with-profits fund became a "closed fund". The practical effect of this was that, whilst policyholders could continue making contributions

under their policies and should expect benefits to be paid out in line with contractual obligations, it was likely that future investment performance would be impaired given the prudential constraints on Equitable Life's freedom of investment. Although Equitable Life's with-profits fund was not insolvent, there were considerable uncertainties amongst policyholders as to the likely future performance of the fund and as to how the assets of the fund would be shared among them.

1.6.3 On 19 December 2000, Mr Richard Ottaway, MP for Croydon South, secured a debate in the House of Commons on the subject of Equitable Life. In response to the concerns voiced during the course of that debate, the Economic Secretary to the Treasury ("EST"), reported that the Board of The Financial Services Authority ("FSA") would be invited by its Chairman to initiate a review of events that led to Equitable Life's decision to close to new business.

1.6.4 Against this background, the FSA issued a press release dated 22 December 2000 reporting that it had appointed Ronnie Baird, Director, Quality Assurance and Internal Audit, assisted by independent legal and actuarial advisers, to produce a full account of the FSA's regulation of Equitable Life for its consideration, to cover the period from 1 January 1999 until Equitable Life's closure to new business on 8 December 2000.

1.7 The Review

1.7.1 PricewaterhouseCoopers and Norton Rose were appointed as independent experts to assist in actuarial and legal matters respectively. Together with Mr Baird and Mr Edridge, a member of his staff, they form the Review Team. This Report has been prepared by the Review Team for the sole use of the Board of the FSA. Consequently, no other party may use this Report for any other purpose.

1.7.2 This Report has been prepared in accordance with the following Terms of Reference:

- (a) The reporting team will be led by the FSA's Director, Internal Audit, Ronnie Baird, who has been asked by the Board of the FSA to provide it with an independent account with the benefit of impartial professional support from external experts.
- (b) The report will cover:
 - (i) the FSA's discharge of the functions (under the Insurance Companies Act 1982) which it undertakes as delegate for HM Treasury; and
 - (ii) the Personal Investment Authority's discharge of its functions as a recognised self-regulating organisation (under the Financial Services Act 1986).
- (c) The report will:
 - (i) describe the background and events leading up to the FSA's assumption of responsibility for the prudential regulation of Equitable Life on 1 January 1999;
 - (ii) describe the course of supervisory work from then until Equitable Life's closure to new business on 8 December 2000;
 - (iii) identify any lessons to be learned.
- (d) The report will access all relevant information within the possession or control of the FSA, the PIA, and their advisers.

(e) The report will be made as soon as possible, though it is recognised that it is likely to take a number of months to finish. It will be published.

1.7.3 The Review Team has been provided with the relevant files by Her Majesty's Treasury ("HMT"), the FSA and the Government Actuary's Department ("GAD").

1.7.4 The Review Team carried out interviews with directors and employees of the FSA (who include former employees of HM Treasury ("HMT")) and GAD. On all occasions, interviews were carried out at the FSA's offices at North Colonnade, Canary Wharf. Some of the interviewees were interviewed on more than one occasion. All the interviewees were accompanied by Freshfields Bruckhaus Deringer, external legal advisers appointed by the FSA. In addition, the Treasury Solicitor attended the interviews with GAD officials. The Review Team wishes to acknowledge its appreciation for the co-operation and assistance which has been extended to it by all those who have been asked to assist.

1.7.5 The FSA, and certain of the relevant divisions involved within the FSA and GAD, were invited to make representations and observations on any preliminary proposed conclusions prior to the finalisation of this Report. Careful consideration has been given to the representations and comments made. Changes have been made when points have been accepted.

1.7.6 The Terms of Reference confined the Review Team to a review of the discharge by the FSA and the Personal Investment Authority ("PIA") of their respective functions and directed it to have access to all relevant information within the possession or control of the FSA, the PIA and their advisers. The Review Team has not had access to documents from any third parties. In particular, it was not deemed appropriate or necessary to extend the Review to include obtaining access to documents in the possession of Equitable Life or any of its advisers or to interviewing any employees or former employees of Equitable Life or any of its advisers. The Review Team wishes to make it clear that it has not sought, nor found it necessary, to draw or express any conclusions about the conduct of Equitable Life's business and it would be wrong to infer fault on the part of Equitable Life or any of its employees (or former employees) from the contents of this Report.

1.8 The Review Team's Approach

1.8.1 In its press release announcing the appointment of the Review Team, the FSA Board stated:

"The Board believes that it is good discipline to learn the regulatory lessons from episodes such as this while acknowledging the fact that the Equitable remains solvent and has not 'failed'."

1.8.2 The purpose of the Review therefore has been to examine what happened in order to identify what lessons can be learned by the FSA from this episode. The Review Team has not seen it as its task to investigate with a view to apportioning blame to any individual in any way. Accordingly, where possible, the Review Team has avoided identifying individual participants at the FSA. It should also be clearly understood that in drawing any conclusions in respect of this matter with a view to identifying the lessons for the future, the Review Team has not sought to exclude the benefit of hindsight.

1.9 The Report

1.9.1 The matters which are the subject of this Report require an understanding of several relatively complex features of Equitable Life's business and the regulatory framework in order for the reader to appreciate the context in which the regulator

was operating and the issues with which it was dealing. The following two chapters of the Report therefore give a detailed explanation of these features.

- 1.9.2 **Chapter Two** deals with the regulatory structure, within which both the prudential² and conduct of business³ regulation of Equitable Life operates and describes the regulatory matrix, within which a complex web of professional, contractual and statutory responsibilities is shared primarily between the Appointed Actuary, GAD, the Insurance and Friendly Societies Division of the FSA (“**IFSD**”) (formerly, when part of HMT, the Insurance Directorate (“**HMT-ID**”)), the PIA and the Investment Business Division (“**IBD**”) of the FSA.
- 1.9.3 **Chapter Three** describes the nature of the GAOs contained in some of Equitable Life’s policies and the approach adopted by the Board of Equitable Life to deal with this problem. It also explains the solvency regime set out in the Insurance Companies Act 1982 (“**ICA 1982**”) and its associated regulations and prudential and professional actuarial guidance and how these applied to the GAO issue.
- 1.9.4 In **Chapter Four**, there follows a narrative account of:
- (a) the background and events leading up to the FSA’s assumption of the responsibilities for prudential regulation of Equitable Life on 1 January 1999 (“**Inheritance Period**”); and
 - (b) the course of the supervisory work from 1 January 1999 until Equitable Life’s closure to new business on 8 December 2000 (the “**Review Period**”).
- 1.9.5 In **Chapter Five** there follows a narrative account of the FSA’s discharge of the functions of the PIA.
- 1.9.6 In **Chapter Six** we give an assessment of the discharge by the FSA and the PIA of their statutory functions and in **Chapter Seven** we identify the lessons to be learned. The content of Chapter Seven has been discussed with the FSA Board prior to finalisation in order to ensure that any recommendations we made were practicable and proportionate.
- 1.9.7 In this Report we have included a number of quotations from various documents. In order to assist reading, we have corrected small, obvious typographical errors.

²The objective of prudential regulation of life insurance companies can be summarised as to protect consumers by ensuring that persons or companies who are not fit and proper or appropriately resourced do not carry on insurance business in the UK.

³The aim of the conduct of business regulator is to protect investors by the regulation and supervision of the retail investment sector, enabling investors to make properly informed decisions in an open, competitive and innovative market place.

Chapter Two

The Regulatory Structure

2.1 Introduction

- 2.1.1 This Chapter describes the regulatory structure which applied to Equitable Life during the Review Period.
- 2.1.2 At present, life insurance companies are subject to two separate regulatory regimes:
- (a) Prudential regulation which relates primarily to the solvency of insurance companies and the soundness and prudence of their management. Prudential regulation is governed by the ICA 1982.
 - (b) Conduct of business regulation which relates primarily to the marketing and sale of retail investment products and advising investors on their rights in relation to such products. Conduct of business regulation is governed by the Financial Services Act 1986 (“**FSAct 1986**”).
- 2.1.3 Historically, prudential regulation and conduct of business regulation have been carried out by separate regulators. Since the early 1980s there have been three different regulatory bodies involved in the prudential regulation of insurance companies. Until the end of 1997, the Department of Trade and Industry (“**DTI**”) held responsibility. In January 1998, responsibility was transferred to HMT which, with effect from 1 January 1999, contracted out its role in the prudential regulation of insurance companies to the FSA. Since 1994, the PIA has had responsibility for conduct of business regulation but, with effect from 1 June 1998, contracted out its role to the FSA.
- 2.1.4 In May 1997, the Government announced its decision to establish a single regulator responsible for banking, investment business and insurance operating under a single legislative framework. The FSA will become the single regulator for financial services in the UK later this year when the Financial Services and Markets Act 2000 (“**FSMA 2000**”) is implemented in full.
- 2.1.5 Until full implementation of the FSMA 2000, the responsibility for managing the regulation of these industries has been transferred to the FSA on a transitional basis. There are a series of complex interim arrangements in place, the effect of which is as follows:
- (a) HMT remains formally responsible for the prudential regulation of insurance companies but has contracted out its functions and powers (with some exceptions) to the FSA; and
 - (b) The PIA is formally responsible for conduct of business regulation but the task of monitoring compliance with its rules is contracted out to the FSA.
- 2.1.6 This Chapter describes in further detail the statutory and contractual framework in which prudential and conduct of business regulation operated during the Review Period. It also describes the various bodies involved in the regulation of Equitable Life and the elements of the regulatory regime.

Prudential Regulation

2.2 Introduction

2.2.1 IFSD told us that:

“The objectives of prudential supervision of life insurance companies can be summarised as to protect consumers by ensuring that persons or companies who are not fit and proper or appropriately resourced do not carry on insurance business in the UK. This is largely achieved through a system of authorisation under the ICA 1982 which requires companies to demonstrate initially that they meet the necessary standards and through the monitoring of companies’ compliance with those standards while they are authorised.”

2.2.2 In regulating authorised insurance companies, the main objective is to protect policyholders against the risk of companies being unable to pay valid claims. In the case of life insurance companies, this includes the risk that they will be unable to meet policyholders’ reasonable expectations (“**PRE**”). PRE is a concept which features significantly in this Report; it is explained in more detail below.

2.3 The Statutory and Contractual Framework

2.3.1 Until 4 January 1998, the DTI was responsible for the prudential regulation of insurance companies. The team within the DTI with immediate responsibility for prudential insurance regulation was known as the Insurance Directorate (the “**ID**”).

2.3.2 Following the Government’s announcement in May 1997 to establish a single regulator, on 5 January 1998, the functions and powers which had formerly been carried out by or on behalf of the Secretary of State for Trade and Industry were transferred to HMT. From 5 January 1998 until 1 January 1999 HMT assumed direct responsibility for the prudential regulation of insurance companies.

2.3.3 Although there was a formal transfer of responsibility for prudential regulation from the DTI to HMT¹, in practice, the day-to-day regulation was carried out by the same staff at ID at the same premises who temporarily joined HMT pending the transfer to the FSA. In this Report we refer to the Insurance Directorate at HMT as “**HMT-ID**”.

2.3.4 Responsibility for the prudential regulation of insurance companies was, in most respects, contracted out to the FSA from HMT with effect from 1 January 1999 although some of the regulatory powers under the ICA 1982 remain exercisable only by HMT. This transfer was effected by means of a Contracting Out Order² and a service level agreement between HMT and the FSA dated 18 December 1998 (the “**Treasury SLA**”). The staff who had comprised HMT-ID moved to the FSA’s offices in Canary Wharf where they were joined by the supervisory staff of the Friendly Societies Commission. IFSD is the division of the FSA with responsibility for the prudential regulation of insurance companies and friendly societies.

2.4 The Treasury SLA

2.4.1 In order to understand the aims and objectives of the regime of prudential regulation as it applied during the Review Period and therefore the role of IFSD, it is necessary to set out, in some detail, some of the provisions of the Treasury SLA.

2.4.2 By virtue of the Treasury SLA, HMT conferred authorisation on the FSA to carry out certain statutory powers and functions of HMT. The statutory powers and functions

¹ Transfer of Functions (Insurance) Order 1997 (SI 1997 No 2781).

² The Contracting Out (Functions in Relation to Insurance) Order 1998 (SI 1998 No. 2842).

which have been delegated to the FSA are set out in a schedule to the Treasury SLA, by way of reference to certain sections of the ICA 1982 and other statutes and secondary legislation. These functions and powers include the following:

- (a) to grant authorisation to carry on insurance business and to suspend or withdraw authorisation;
- (b) to receive the regulatory returns of an insurance company;
- (c) to require a company in breach of its margin of solvency to submit a plan for the restoration of a sound financial position;
- (d) to require a company which fails to maintain its minimum margin of solvency (as defined in the legislation) to submit a short term financial scheme;
- (e) to impose requirements about investments;
- (f) to require the maintenance of assets in the UK;
- (g) to impose requirements with respect to the custody and disposal of assets;
- (h) to limit the premium income;
- (i) to require a company to make an investigation into its financial condition;
- (j) to require a company to submit its annual returns early;
- (k) to obtain information and require the production of documents; and
- (l) the residual power to impose requirements for the protection of PRE³.

2.4.3 The introduction to Schedule 1 to the Treasury SLA states:

“This Schedule sets out the aims and objectives which the FSA is to adopt in respect of the functions which the FSA is authorised to exercise on behalf of the Treasury, and defines the standards and performance measures which the FSA will use its best endeavours to achieve.”

2.4.4 Under the heading “Aims and Objectives”, Schedule 1 refers to the draft legislation⁴ which had been published on 30 July 1998. The FSA’s objectives which were set out in that draft legislation and which are recited in Schedule 1, were:

- (a) maintaining confidence in the UK financial system;
- (b) promoting public understanding of the financial system, including awareness of the benefits and risks associated with different kinds of investment or other financial dealing;
- (c) securing the appropriate degree of protection for consumers, having regard to the differing degrees of risk involved in different kinds of investment or other transaction, the differing degrees of experience and expertise which different consumers may have, and the general principle that consumers should take responsibility for their decisions; and

³ The powers of intervention, and the grounds upon which they may be exercised, are considered in further detail below.

⁴ The Financial Services and Markets Bill.

- (d) reducing the extent to which it is possible for a business that is carried on by a regulated person to be used for a purpose connected with financial crime.

2.4.5 Schedule 1 goes on to state:

“While these objectives are not yet enacted and may be amended during the passage of the legislation they serve to inform the general approach the FSA proposes to take during the period prior to the new legislation coming into force (“N2”). This will include the FSA’s approach to carrying out the functions which it will exercise on behalf of the Treasury for insurance supervision.

The FSA’s aim will be effectively to regulate the insurance industry so that policyholders can have confidence in the ability of UK insurers to meet their liabilities and fulfil policyholders’ reasonable expectations.”

2.4.6 The following are said to be the FSA’s “key supporting objectives”:

- (a) to ensure that persons or companies who are not fit and proper or appropriately resourced or otherwise not able to satisfy the criteria for authorisation do not carry on business in the UK;
- (b) to carry out the regulation of insurance companies...efficiently and effectively;
- (c) to meet the insurance industry’s reasonable requests for prompt and clear responses to their requests for information and advice and to keep the cost and inconvenience of regulation for insurers as low as is commensurate with effective protection of the consumer; and
- (d) to co-operate with HMT in seeking to deliver the efficient operation of the single market, including assistance in EU negotiations and to secure that EC law develops to maximise an open and competitive market in the EU.

2.4.7 Under the heading “Insurance Supervision Work Programme” the Schedule sets out the key areas of work for 1999. The key areas of work which are identified are:

- (a) conduct of on-going regulatory, and related, work to specified standards;
- (b) initiatives to support the development of more effective and efficient regulatory procedures; and
- (c) preparation for the coming into effect of the new regulatory regime.

2.4.8 The Schedule then goes on to amplify these areas of work. So far as the first is concerned, various sub-headings are set out in Schedule 1. These include a sub-heading “Supervision” under which the FSA’s “General responsibilities”, “Key tasks” and “Performance Measures” are described. The “General responsibilities” include the following:

“Protecting policyholders against the risk of company failure and, more specifically, to protect them against the risk that UK authorised insurers might be unable to pay valid claims. In the case of life insurance companies this includes the risk that they will be unable to meet policyholders’ reasonable expectations. The Treasury and FSA agree that it is neither realistic nor necessarily desirable in a climate which seeks to encourage competition,

innovation and consumer choice, to seek to achieve 100% success in avoiding company failure. The FSA will therefore pursue its supervisory objectives by aiming to minimise, but not eliminate, the risk of company failure by identifying early signs of trouble, and taking preventative action.”

2.4.9 Under “Key tasks” the Schedule states that the supervisory resource will be focused on:

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

2.4.10 As set out above, another key area of work which is identified in Schedule 1 is “Initiatives to support the development of more effective and efficient regulatory procedures.” The activities to be undertaken during the course of 1999 in relation to this area include:

- (a) review, and where necessary, undertake an interim update of non-life and life insurance supervisory procedures and internal guidance to ensure a consistent and properly documented approach (target date April 1999);
- (b) preparation of sectoral and market analyses to improve understanding of the context in which insurance companies operate; and
- (c) the enhancement of a risk-based approach to supervision.

2.4.11 In relation to the last of these, the Schedule notes that:

“As part of its work on procedures, the FSA will further develop a risk-based approach to insurance supervision against the FSA’s broader canvas of financial regulation with a view to aligning the methodology and categorisation, to the extent possible whilst taking account of the particular complexity of assessing insurance companies, with the practice in relation to other sectors of the financial industry. A particular focus of this work will be the identification of the key elements, and the development of a risk rating system which could be implemented within two years of N2, if appropriate ...”

2.4.12 Not all the powers under the ICA 1982 were transferred to the FSA from HMT. The Treasury SLA details the arrangements with respect to these powers⁵. In particular, the power under section 68 of the ICA 1982 to make an order which disapplies, or modifies the application of, certain provisions of the ICA 1982 and certain regulations made under it was not transferred to the FSA. As described in Chapter 3, Equitable Life had the benefit of Section 68 Orders which permitted it to include certain items in its solvency calculation.

2.5 The Regulatory Bodies: IFSD

2.5.1 IFSD is the division within the FSA which has responsibility for the prudential regulation of insurance companies. During the Review Period it was divided into four departments: life, non-life, London market and policy and international.

⁵ Treasury SLA, Schedule 1, para 16.

- 2.5.2 So far as life insurance is concerned, at the beginning of the Review Period, IFSD consisted of: 1 Head of Department, 4 managers, 13 associates and 5 administration/secretarial staff.
- 2.5.3 At the end of the Review Period, the breakdown of the staff was: 1 Head of Department, 4 managers, 17 associates and 5 administration/secretarial staff.
- 2.5.4 During the Review Period, there were approximately 200 firms (consisting of approximately 150 life insurance companies and 50 composite insurance companies) regulated by this section of IFSD.

2.6 The Regulatory Bodies: Insurance Supervisory Committee

- 2.6.1 Although IFSD has day to day responsibility for prudential regulation of insurance companies, the FSA Board has delegated, ultimately, to the Insurance Supervisory Committee (the “ISC”) the exercise of any power or discretion which has been conferred on the FSA by the Treasury SLA. The remit of the ISC is to:
- “consider any exercise of any power or discretion conferred by the [ICA 1982] in relation to any insurer, within the remit of IFSD. This includes any recommendation to the Treasury to exercise supervisory powers that the FSA has not been authorised to exercise, notably to issue Orders under s68.”
- 2.6.2 The members of the ISC are the Director of IFSD, Heads of Department, the Head of the Policy Unit and all managers with line responsibility for the supervision of insurance companies. GAD may attend meetings of the ISC for papers on which it has a particular contribution to make.

2.7 The Regulatory Bodies: General Counsel’s Division

- 2.7.1 IFSD obtains legal advice from the General Counsel’s Division of the FSA (“GCD”). In the period from 5 January 1998 to 31 December 1999, when prudential regulation was the responsibility of HMT, legal advice was provided to HMT-ID by the Treasury Advisory Division (“TAD”).
- 2.7.2 We were told that GCD largely provided legal advice when asked to do so by IFSD. GCD’s advice was sought when IFSD required specific legal input because a regulatory issue had a legal dimension to it. The legal issues which GCD dealt with ranged from being relatively routine to “bigger supervisory issues of which Equitable was the classic example.”
- 2.7.3 IFSD informed us that:
- “a lot of supervision of insurance companies goes on without that much legal advice. It tends to be the exception where a specific point has been raised that clearly has a legal aspect to it, then the lawyers are asked for specific advice but normally for company’s supervision they don’t have that sort of ongoing role...In Equitable’s case there was more of an ongoing approach, largely because the court case was ongoing throughout the period and there clearly was that legal side to it.”
- “So in this case...the lawyers became involved really at an early stage, [and] took an interest and effectively monitored the case throughout. They were routinely copied in correspondence, so had there been any issue they wanted to raise they could do.”

2.8 The Regulatory Bodies: Government Actuary's Department

- 2.8.1 IFSD obtains actuarial advice from GAD.
- 2.8.2 GAD was established by HMT in 1919. It consists of three directorates which, in broad terms, are concerned with occupational pension schemes, social security and insurance supervision. The head of GAD is the Government Actuary. GAD's role is advisory; it has no responsibility for the exercise of statutory powers under the ICA 1982.
- 2.8.3 Since 1984, GAD has operated a major part of life insurance supervision, as a delegated responsibility, under the terms of a service level agreement originally with the DTI, subsequently with HMT and now with the FSA, as the prudential regulators (the "GAD SLA"). The GAD SLA sets out the detailed services to be provided by GAD. In particular, GAD has the main role in the scrutiny of the regulatory returns and in providing advice to IFSD on what action needs to be taken in following up points arising from the scrutiny.
- 2.8.4 The product of GAD's examination of the regulatory returns is a "scrutiny report" which forms a key element of the regulatory process of the FSA. Both the regulatory returns and GAD's scrutiny reports are considered in further detail below.
- 2.8.5 In addition to the scrutiny report (and authorisation processes), GAD also provides advice on areas which impact on a life insurance company's solvency or PRE. To enable GAD to carry out its duties effectively, IFSD are required to copy to GAD all relevant correspondence received from insurance companies. The GAD SLA provides that IFSD will request advice from GAD when there are issues which might affect, for example, the financial security of a life insurance company, PRE, or where the issues raised are actuarial or professional in nature. However, GAD is always free to comment on any document if it believes that there are issues that should be brought to IFSD's attention.
- 2.8.6 In considering whether the company's Appointed Actuary has met his statutory and professional obligations, GAD has regard to standards generally accepted within the profession and to specific research carried out by the profession. In some key areas of interpretation of the valuation regulations (which set out how the value of the assets and liabilities is to be determined for the purposes of determining statutory solvency), GAD has developed its own working rules to define what is acceptable and these have been issued as guidance⁶ in which the Government Actuary sets out details of what GAD considers to be good practice in relation to particular actuarial issues. Two examples of such letters are the letters which were sent in January 1999 and December 1999 on reserving for GAOs which are considered in greater detail in Chapters 3 and 4.
- 2.8.7 In addition, staff from GAD accompany IFSD on visits to life insurance companies and advise IFSD on new authorisations of life insurance companies and on a wide range of policy issues.
- 2.8.8 At the start of the Review Period, there were 10 actuaries, 2 trainee actuaries and 2 administrators/secretaries providing support to IFSD. At the end of the Review Period, the number of actuaries had reduced to 8 (as a result of retirements and resignations). The number of trainee actuaries and administrators/secretaries remained the same. Additional actuarial resource was available to support the supervision of friendly societies and non-life insurance companies.

⁶ Dear Appointed Actuary letters.

- 2.8.9 As of 26 April 2001, the GAD staff involved in the prudential regulation of insurance companies have been transferred to the FSA to provide ‘in-house’ actuarial advice.

2.9 The Prudential Regulatory Matrix

- 2.9.1 Insurance companies are subject to a specific statutory solvency regime which is designed to ensure that they are able to meet their obligations to policyholders. Monitoring the financial soundness of insurance companies is based mainly on the regulatory returns which insurance companies are required to submit each year. IFSD described to us two important elements of the prudential regulatory regime:

“The whole essence of regulation was “freedom with disclosure”. That the substantial amount of information put in the public domain, by contrast to the banking world, allowed the regulator, the analysts, everyone out there to look and see the position. That as it were allowed a much more relaxed system of regulation than was the case in many other countries and that had been so since the twenties or thirties. So that is one part of it. The other part of it...is the reliance on the appointed actuary and his statutory responsibilities. He was conceived by the actuarial profession certainly as rather a guardian of PRE and almost, if not in legal terms, almost a trustee of policyholders. So he was a safeguard there to make sure that decisions were taken properly and carefully and with proper regard to contractual liabilities and PRE. You have the professional guidance of the Institute, discipline and all that.”

- 2.9.2 In the sections which follow we describe these two elements in further detail. We first explain, in broad terms, the contents of the regulatory returns and how these are scrutinised by GAD. We then explain the role of the Appointed Actuary in the regulatory structure.

2.10 The Regulatory Returns

- 2.10.1 In addition to the annual report and accounts which are required under the Companies Act 1985, section 22 of the ICA 1982 requires a UK life insurance company to submit to the FSA each year a series of reports which are known as the “regulatory returns”⁷. (They are also referred to as the “annual” or “supervisory” returns.) They are the principal tool for enabling the FSA to form a view on an insurance company’s present and future solvency.
- 2.10.2 The Insurance Companies (Accounts and Statements) Regulations 1996 (the “**1996 Regulations**”) set out in detail the information required in the regulatory returns and the format in which the information is to be presented.
- 2.10.3 At present, the regulatory returns are required to be submitted to the FSA within 6 months of the year-end (which is also referred to as the “valuation date”⁸). Equitable Life’s year end was 31 December so its returns were required to be submitted to the FSA by 30 June. The regulatory returns are filed as a public document at Companies House. The regulatory returns are significantly longer and more detailed than a company’s annual report and accounts. Equitable Life’s regulatory returns for 1999, for instance, ran to 420 pages.
- 2.10.4 The regulatory returns are laid out as a series of Schedules. Of particular relevance to this Report are:

⁷ The FSA may also require the company to provide more frequent returns. Hence a new insurance company is normally required to submit quarterly returns.

⁸ Section 22 ICA 1982. The timetable for submission of the regulatory returns will change from N2.

- (a) Schedule 1, which gives a detailed analysis of the assets and liabilities making up the solvency position of the insurance company. Schedule 1 includes, amongst other matters, Forms 9, 13 and 14. Form 9 is the consolidated regulatory balance sheet. It includes a comparison of the excess of “available assets” over liabilities with the excess required by regulations (which is known as the “required minimum margin” or “RMM”). Form 13 sets out the available assets analysed by type of asset. Form 14 shows the long-term liabilities relating to insurance policies and the short-term liabilities of the company. The totals for assets and Form 14 liabilities are carried into Form 9 as the key elements of the regulatory balance sheet.
- (b) Schedule 4, which describes in detail the approach taken and assumptions made by the Appointed Actuary in determining the liabilities. Schedule 4 also derives the surplus available in the year and sets out how the surplus is allocated to policyholders and shareholders, if any. Schedule 4 also contains detailed financial information on different insurance products issued by the company. Schedule 4 contains, *inter alia*, Forms 51 to 54, which detail the liabilities established for the various types of policies; Form 57 which describes the calculation of the resilience reserve; Form 58 which sets out the aggregation of the liabilities from Forms 51 to 54 and the surpluses emerging in the year; and Form 60, which describes the calculation of the RMM. The total of liabilities derived in Form 58⁹ is carried forward into Form 14 where it constitutes the liability for long-term business. The RMM calculated in Form 60 is carried into Form 9.

2.10.5 The regulatory returns also include a certificate from the Appointed Actuary. The contents of this certificate are described in further detail below. Chapter 3 provides an explanation of the statutory solvency regime and how the value of assets and liabilities is to be determined for the purposes of the regulatory returns.

Role of the auditors

2.10.6 In contrast to the report and accounts required under the Companies Act 1985, the 1996 Regulations provide that only specific parts of the regulatory returns are covered by an opinion from the auditors¹⁰. The auditors’ report is not an opinion on a “true and fair” view but is a report on whether the particular parts of the regulatory returns which are subject to audit have been properly prepared in accordance with the 1996 Regulations. In particular, the auditors do not report on Schedule 4; nor do the auditors report on implicit items¹¹ which are shown on Form 9 of the regulatory returns.

2.10.7 The auditors have a duty under the Auditors (Insurance Companies Act 1982) Regulations 1994 to report to the regulator any matters which the auditors believe are of material significance to the regulator for determining whether to exercise any of its powers of intervention. The powers of intervention are considered in further detail below.

2.11 GAD’s Scrutiny of the Regulatory Returns

2.11.1 GAD performs an initial scrutiny of the regulatory returns. For a company which has submitted its regulatory returns by the end of June, GAD aims to have performed the initial scrutiny by the end of August. The initial scrutiny report consists of:

⁹ This figure is referred to as the “mathematical reserves”.

¹⁰ Regulation 29 of the 1996 Regulations.

¹¹ Implicit items are described in Chapter 3.

- (a) a priority rating for each company based on the criteria set out in the GAD SLA and taking account of a number of indicators;
- (b) an indication of solvency cover for each company; and
- (c) a target date for full scrutiny of each company’s regulatory returns.

2.11.2 The priority rating system has five levels:

- (a) Priority 1 is allocated to companies which are either not demonstrating that they hold the RMM or where there are significant problems which lead GAD to believe that they do not meet the requirements under proper bases.
- (b) Priority 2 is allocated to companies where there are “significant and substantial concerns”. The indicators of such concerns include where the cover for RMM (i.e. the ratio of the value of assets in excess of the liabilities to the RMM) is less than 1.25x or there is evidence of material non-compliance with the valuation regulations.
- (c) Priority 3 is allocated to companies where there are sufficient concerns to warrant early attention or there are other reasons to require scrutiny early in the cycle. The indicators for this priority rating include where the cover for RMM is less than 1.5x or there is evidence of non-trivial but not material non-compliance with the valuation regulations.
- (d) Priorities 4 and 5 are allocated to companies whose regulatory returns are targeted for scrutiny within nine and eleven months respectively.

2.11.3 IFSD told us that:

“the priority ratings do not take account of the potential “impact” of failure of the company concerned (they essentially relate only to the “probability” of failure). While throughout the Review Period other life companies were assessed as more likely to fail, and so received a higher GAD rating, I think it is fair to say that overall none of those companies was seen as a greater overall risk and accorded more supervisory importance than Equitable Life.”

2.11.4 The GAD SLA provides that GAD will report immediately to IFSD if its initial scrutiny of any insurance company raises “serious concern”. Examples which are given in the GAD SLA of where serious concerns arise include the situation when a company has failed to meet its solvency margin or is in financial difficulties¹².

2.11.5 The GAD SLA provides that both GAD and IFSD will use their best endeavours to agree the time-tabling and allocation of priority ratings by mid-September. Provision of detailed scrutiny reports by GAD is prioritised according to the priority rating and the target for Priority 1 and 2 cases is the end of October. However, the GAD SLA states that GAD does not need to wait for the scrutiny programme to be agreed before starting the detailed scrutinies of what it perceives to be the most urgent cases.

2.12 The Scrutiny Report

2.12.1 The role of GAD in the detailed scrutiny process is to provide IFSD, in a standard report (called a “scrutiny report”), with a means of identifying and considering actions against those companies which:

¹² GAD SLA Section 5, A7.

- (a) are not complying with statutory requirements;
- (b) are failing to meet the solvency requirements, or are in danger of failing to meet them in the near future; or
- (c) appear not to be meeting PRE¹³.

2.12.2 The scrutiny report is the primary document on which IFSD bases its understanding of the financial soundness of an insurance company. Key sections include:

- (a) New Business: new products and new premium income;
- (b) Changes in business in force: premium income and claims and lapse experience;
- (c) Expenses;
- (d) Assets: type of assets;
- (e) Valuation: the bases, resilience test, options and guarantees;
- (f) Financial results;
- (g) Bonuses and PRE; and
- (h) Reinsurance agreements and financing arrangements.

2.12.3 In addition, the scrutiny report will include information on a basis for action in relation to an insurance company if any of these requirements are not being met or if trends in key performance indicators point to problems in the future or the scrutiny report will contain a basis for informed longer term discussion. The GAD SLA gives the following key performance indicators:

- (a) cover for the solvency margin and trends in free asset ratios;
- (b) actuarial issues (e.g. change in strength of valuation basis; matching);
- (c) type of new business being written, by volume and mix;
- (d) trends in expense ratios;
- (e) trends in lapse rates;
- (f) assets; worrying exposures, investment strategy, impact on bonus strategy; and
- (g) significant developments during the year¹⁴.

2.13 The Appointed Actuary

2.13.1 The second important element of the regulatory matrix is the Appointed Actuary.

¹³ GAD SLA Section 5, A8.

¹⁴ GAD SLA Section 5, A9.

- 2.13.2 Under section 19 of the ICA 1982 every life insurance company is required to appoint an actuary, who is known as the Appointed Actuary, to undertake certain duties.
- 2.13.3 The 1996 Regulations prescribe¹⁵ that an Appointed Actuary must be a Fellow of the Faculty of Actuaries (the “**Faculty**”) or of the Institute of Actuaries (the “**Institute**”) (the controlling bodies for actuaries in the United Kingdom) and have attained the age of 30. Before taking up the position, an Appointed Actuary must obtain from either the Faculty or the Institute a practising certificate authorising him to act in this capacity. Such a certificate will only be issued if the applicant is able to demonstrate to the Faculty or Institute that he has the relevant experience to undertake the duties of an Appointed Actuary, that he has complied with the scheme of continuing professional development and that he is fit and proper to act as an Appointed Actuary. The practising certificate is renewable annually.
- 2.13.4 In addition, under the GAD SLA, all new Appointed Actuaries (who have not previously held such a position) are to be interviewed by the Government Actuary and a note of the meeting forwarded to IFSD. Any changes of Appointed Actuary are notified by IFSD to GAD and it will liaise with IFSD over any action that is needed where there is any concern about the reasons for the change of Appointed Actuary¹⁶.
- 2.13.5 The Faculty and the Institute issue professional Guidance Notes. These Guidance Notes are either mandatory (referred to as “practice standard”) or regarded as best practice (in which case they are referred to as “recommended practice”). Evidence of a failure to comply with practice standards could lead to disciplinary action by the profession.
- 2.13.6 The relationship between the Appointed Actuary and the board of directors of an insurance company is one which is regarded by the profession as being between a professional and his principal. The normal professional relationship of confidentiality and independence of advice applies, whether the Appointed Actuary is an employee or an external consultant. The Appointed Actuary, as such, has no executive powers and, in many cases, is not a board member. It is his duty to advise the board of directors. However, as in the case of Equitable Life, many Appointed Actuaries also hold senior executive positions within life insurance companies.
- 2.13.7 The Appointed Actuary is appointed by the board of directors of the life insurance company and, equally, can be replaced by the directors if they so choose. However, if an Appointed Actuary is replaced, the incoming actuary must consult the outgoing actuary to ensure that there is no matter of professional concern of which he should be aware. Further, the directors must inform IFSD that the Appointed Actuary has changed and IFSD may choose to seek further information on the circumstances of the change if it wishes.

2.14 The role of the Appointed Actuary

- 2.14.1 In a paper published by the Faculty and Institute entitled “The Role of the Appointed Actuary”¹⁷ the Appointed Actuary system was described as:

“central to the financial soundness of life companies in the UK.

¹⁵ Regulation 30.

¹⁶ GAD SLA Section 5, C1.

¹⁷ May 2000.

The Appointed Actuary has responsibilities to the Company’s Board of Directors, to its policyholders and to [IFSD] for monitoring and reporting on the Company’s financial progress. It is his or her duty to assess the implications for the Company’s financial condition of external events and the Company’s own actions, and to advise the Company accordingly.”

2.14.2 The Appointed Actuary has wide responsibilities in relation to monitoring, on a continuing basis, the adequacy of the company’s assets to meet its liabilities. In particular, the Appointed Actuary is required by section 18 of the ICA 1982 to investigate each year the financial condition of the life insurance company and report on the findings to the directors. This includes a valuation of the company’s long-term liabilities and a calculation of any excess of its long-term assets over its long-term liabilities.

2.14.3 An abstract of the Appointed Actuary’s report to the board of directors is included in the regulatory returns¹⁸. In addition, the regulatory returns include a certificate from the Appointed Actuary¹⁹ in which he certifies:

- (a) that proper records have been kept adequate for the valuation of the company’s liabilities;
- (b) that proper provision has been made for the liabilities;
- (c) the amount of the minimum solvency margin which the company is obliged to maintain;
- (d) that premium rates for new business are adequate to enable the company to meet its commitments under the contract;
- (e) that the relevant guidance issued by the Faculty and Institute has been complied with; and
- (f) that the assets and liabilities have been valued in accordance with the Insurance Companies Regulations 1994 (“**1994 Regulations**”).

Where this certificate cannot be given without qualification, this must be stated and explained.

2.14.4 The Faculty and Institute’s paper referred to above acknowledged that:

“The process of valuation, reporting and certification by the Appointed Actuary enables the [regulator] to monitor the Company’s financial progress without carrying out its own detailed investigations.”

2.14.5 The Appointed Actuary’s responsibilities are described in Guidance Notes issued by the Faculty and Institute. The Guidance Notes place a professional duty on the Appointed Actuary rather than imposing any statutory duty. Of particular relevance to this Report are: “Guidance Note 1: Actuaries and Long-Term Insurance Business” (“**GN1**”) and “Guidance Note 8: Additional Guidance for Appointed Actuaries and Appropriate Actuaries” (“**GN8**”). Both GN1 and GN8 are designated as “practice standard” which means that they are, in effect, mandatory for Appointed Actuaries.

¹⁸ Section 22 ICA 1982.

¹⁹ Regulation 28 of the 1996 Regulations.

- 2.14.6 GN1 deals with general matters and GN8 deals with the interpretation of the valuation regulations. GN1 makes it clear that an important aspect of the Appointed Actuary's role is the duty to advise the board on the interpretation of PRE. The provisions of GN1 are therefore considered in more detail below in the section relating to PRE. Both GN1 and GN8 are also considered in more detail in Chapter 3.
- 2.14.7 In addition to GN1 and GN8, "Guidance Note 2: Financial Condition Reports" ("GN2") is also relevant. GN2, which is designated recommended practice, sets out the profession's view on the advisability of supplementing the annual investigation into a company's financial condition with a report to the directors on the results of a dynamic financial analysis. This dynamic financial analysis involves testing the company's ability to withstand possible future adverse conditions, making use of cash flow projections on a variety of assumptions.
- 2.14.8 The Guidance Notes envisage that there may be occasions on which the Appointed Actuary might need to advise the prudential regulator directly of a situation where the company is following a course of action which could lead him to qualify a subsequent actuarial certificate. This situation is seen as being a rare occurrence and would only arise if the company's directors had previously chosen to ignore clear advice from the Appointed Actuary.

2.15 Intervention by the Prudential Regulator

- 2.15.1 Intervention by a regulator usually denotes the exercise of formal powers of intervention prescribed by the relevant legislation. This obviously does not exclude the regulator from intervening in a less formal way with a view to enquiring, discussing and perhaps even questioning management decisions that give rise to regulatory concerns or potential concerns.
- 2.15.2 IFSD told us:
- "our powers are very broad and very sweeping. They are quite strong powers, but they are very general. And we have found it effective to engage in discussion with companies about what a problem is and to try to reach agreement with them on an appropriate way forward. It is a fact of life that companies know we have got these powers, and although we don't, I hope, abuse them, the club held behind the back can often get a quicker result, and a more effective result, than a formal exercise which would mean a very protracted and possibly difficult process."
- 2.15.3 This section summarises the formal powers of intervention available to the prudential regulator under the ICA 1982 and the grounds upon which they may be exercised.

2.16 Powers of intervention

- 2.16.1 In the case of a UK insurance company²⁰, the ultimate sanction available to the FSA is the withdrawal of authorisation (in whole or in part) so as to prevent an insurance company entering into any new contracts of insurance or new contracts of insurance of a particular description²¹.
- 2.16.2 The FSA also has powers in certain defined situations with respect to the investments and the maintenance, custody and disposal of assets by insurance companies. It may also:

²⁰ An insurance company which is incorporated, and has its head office, in the UK.

²¹ Sections 11 and 13 ICA 1982.

- (a) require an insurance company to limit the premium income which it underwrites²²;
- (b) require a company which carries on long-term business to institute an actuarial investigation by its Appointed Actuary into its financial condition in respect of that business or any part of it²³;
- (c) require the regulatory returns to be delivered on an earlier date (up to three months before the normal due date)²⁴; and
- (d) require a company to provide the FSA at specified times or intervals with information about specified matters, verified, if the FSA so requires, in a specified manner²⁵.

2.16.3 Under section 45 of the ICA 1982, the FSA also has a power:

“to take such action as appears to [the FSA] to be appropriate:

- (a) for the purpose of protecting policyholders or potential policyholders of the company against the risk that the company may be unable to meet its liabilities, or, in the case of long-term business, to fulfil the reasonable expectations of policyholders or potential policyholders; or
- (b) ...for the purpose of ensuring that the criteria of sound and prudent management are fulfilled with respect to the company.”

This is a residual power and is only exercisable where the purpose prescribed is not achievable by the exercise of any of the other powers.

2.17 The Grounds for Intervention

2.17.1 Section 37 of the ICA 1982 sets out the grounds on which the powers of intervention may be exercised. These grounds include:

- (a) when it appears that any of the criteria of sound and prudent management is not, or has not been or may not be or may not have been fulfilled²⁶; and
- (b) when [the FSA] considers the exercise of the power to be desirable for protecting policyholders or potential policyholders of the company against the risk that the company may be unable to meet its liabilities or, in the case of long-term business, to fulfil the reasonable expectations of policyholders or potential policyholders²⁷.

2.18 Criteria of sound and prudent management

2.18.1 Schedule 2A to the ICA 1982 sets out the criteria of “sound and prudent management”. The criteria include the following requirements:

²² Section 41 ICA 1982.

²³ Section 42 ICA 1982.

²⁴ Section 43 ICA 1982.

²⁵ Section 44 ICA 1982 (insofar as the exercise of any of these functions would require any individual to produce any documents at such time and place as may be specified, the power has been reserved to HMT).

²⁶ Section 37(2)(aa) ICA 1982.

²⁷ Section 37(2)(a).

- (a) that the business of the insurance company must be carried on with integrity, due care and the professional skills appropriate to the nature and scale of its activities; and
- (b) each director, controller, manager or main agent of the insurance company must be a fit and proper person to hold that position.

2.18.2 The Schedule states that an insurance company will not be regarded as conducting its business in a sound and prudent manner if it:

- (a) fails to conduct its business with due regard to the interests of policyholders and potential policyholders; or
- (b) fails to satisfy an obligation to which it is subject by virtue of the ICA 1982; or
- (c) in the case of a UK company, it fails to satisfy an obligation to which it is subject by virtue of any provision of the law of another EEA State which applies to its insurance business in that state.

2.19 Policyholders' Reasonable Expectations

2.19.1 PRE is a concept which features significantly in this Report and it is necessary to appreciate the statutory context in which it arises and the purpose it purports to serve.

2.19.2 The concept of PRE in relation to long-term insurance business was introduced by the Insurance Companies (Amendment) Act 1973. As described above, it now appears in section 37 of the ICA 1982, as a ground upon which the FSA may exercise any of its powers of intervention where the FSA considers the exercise of that power is desirable for protecting policyholders or potential policyholders against the risk that the company may be unable to fulfil the reasonable expectations of policyholders or potential policyholders. PRE is also repeated as a precondition for the use of the residual power of intervention under section 45 of the ICA 1982.

2.19.3 PRE will rarely, if ever, be a claim or right that can be enforced by a policyholder. There is no specific requirement for life insurance companies to meet PRE and it is not, therefore, open to policyholders to sue for breach of PRE. It is a concept to which an Appointed Actuary must have regard; it is also a ground for intervention by the prudential regulator.

2.20 PRE - the Concept

2.20.1 Between 1990 and 1993, a Working Party of the Faculty and Institute sought:

“to consider the ways in which the expression ‘policyholders’ reasonable expectations’ [had] been used in practice and to recommend how it should be regarded within the UK actuarial profession.”

2.20.2 The Working Party carried out a series of interviews with Appointed Actuaries and attempted to distil key principles. In the event, none of the Working Party’s recommendations became mandatory and no formal guidance resulted. However, some of the principles which were recorded still serve to inform Appointed Actuaries as they prepare advice for their boards of directors.

2.20.3 The following paragraphs from the Working Party’s reports are relevant:

“The primary expectation of policyholders is that all guaranteed benefits will be met in full, regardless of the type of contract. It is also fundamental that the

policyholder has the right to expect that the company's affairs will be managed ethically and with due competence and diligence.

Many life assurance contracts include at least one discretionary element...

The holders of such contracts may reasonably expect that life offices will behave fairly and responsibly in exercising the discretion which is available to them. They may also expect a reasonable degree of continuity in an office's approach to determining variable charges or benefits. Although these are imprecise concepts, there appears to be a fair measure of agreement among actuaries as to how they should be applied in practice.

For with-profits business, PRE will be focused on the total benefit payable in the event of a claim. Policyholders are entitled to expect that benefits will reflect the accumulated value of premiums paid less expenses and the cost of risk benefits, in accordance with the actual experience of the office. In actuarial terminology, asset shares should provide the starting point for determining maturity benefits. The degree to which returns are smoothed over time, and the extent to which part of the asset share is retained to finance future expansion, will vary considerably between offices. It is reasonable to expect that an office will change its policy in these areas only gradually; a sudden move from a passive to an active terminal bonus policy could be considered unreasonable.

...

In general, gradual changes are more likely to be accepted by policyholders as reasonable than major discrete changes. Communication with policyholders during the currency of their policies plays an important part in shaping their expectations and may help to avoid potential problems. Policyholders and their advisers will normally expect continuity in all areas of a life office's operations, including not only new business, investment policy and bonus philosophy but also general culture and management style.

...

In the final analysis it is the [prudential regulator] who is required to decide whether a company may be unable to fulfil the reasonable expectations of its policyholders. Interviews with representatives of the Department of Trade and Industry and the Government Actuary's Department have confirmed that there is no predetermined view of where the dividing line between reasonable and unreasonable behaviour lies; each case is considered according to the individual facts and circumstances."

2.20.4

The concept of PRE was the subject of a Ministerial Statement on 27 February 1995. This set out the views of the DTI (which, at that time, was the prudential regulator) of the factors which influenced PRE in respect of the attribution of surpluses in with-profits funds. These were:

- (a) the fair treatment of policyholders *vis-à-vis* shareholders;
- (b) any statements by the company as to its bonus philosophy and the entitlement of policyholders to a share in profit; for example, in its Articles of Association or in company literature;
- (c) the history and past practice of the company; and
- (d) general practice within the life insurance industry.

- 2.20.5 Implicit in this Ministerial Statement was that policyholders have a reasonable expectation that the terms of their contract will be met but that PRE may also extend beyond the contractual or other legal rights of the policyholder. This has generally been accepted by the actuarial profession and was specifically endorsed by the Vice-Chancellor in his judgment at first instance in the Equitable Life case.

2.21 The role of the Appointed Actuary with regard to PRE

- 2.21.1 In the first instance it is the responsibility of the company, with the advice of its Appointed Actuary, to ensure that it acts in a manner which has regard to PRE. The Appointed Actuary of a life insurance company has the primary role within the company of interpreting PRE in order to advise the board of directors.

- 2.21.2 GN1 contains a number of references to the Appointed Actuary's responsibilities in relation to PRE including the following:

"It is incumbent upon all Appointed Actuaries to ensure, so far as it is within their authority, that the long-term business of the company is operated on sound financial lines and with regard to its policyholders' reasonable expectations."

"It is part of the Appointed Actuary's continuing responsibility to advise the company of the Appointed Actuary's interpretation of its policyholders' reasonable expectations. In general terms this interpretation should have regard to the broad nature of the company and its approach to the treatment of policyholders both individually and (where appropriate) collectively as a group *vis-à-vis* shareholders. When a significant change is likely to take place, the Appointed Actuary should take all reasonable steps to ensure that the company appreciates the implications for the reasonable expectations of its policyholders. It is also incumbent upon the Appointed Actuary to take all reasonable steps to ensure that the company's incoming policyholders should not be misled as to their expectations."

"Under the insurance legislation it is a requirement for continuing authorisation that the company should fulfil certain criteria of sound and prudent management. These criteria are set out in the legislation and include the need for insurance business to be conducted with due regard to the interests of policyholders and potential policyholders. In formulating advice to be given to the company, the Appointed Actuary must take account of these interests."

"When assessing the liabilities of the long-term business of the company the Appointed Actuary must also have regard to policyholders' reasonable expectations."

"The possibility of insolvency, or intervention by the Supervisory Authority on the grounds of the company being unable to fulfil the reasonable expectations of its policyholders, may arise from factors, some of which are within the control of the company and some not. To the extent that they are under the control of the company, it is the Appointed Actuary's duty to assess the limits within which the company must act and to advise the company of the necessity for these limits."

"The Appointed Actuary must justify any recommendations regarding the allocation [of profits] and its consequences (if any) for the conduct of the company's business by reference as appropriate to the Appointed Actuary's:

- (a) appraisal of the relevant experience;
- (b) understanding of the company's financial and business objectives;

- (c) assessment of the company’s continuing ability to meet its statutory solvency requirements; and
- (d) interpretation of the reasonable expectations of the company’s policyholders having regard to (a), (b) and (c). Such expectations are clearly influenced by policy literature and other publicly available information such as own charge illustrations. The Appointed Actuary should assume that among the conditions for the fulfilment of those expectations are:
 - (i) that, in the recognition and allocation of profits in accordance with the company’s terms of participation and its policy in respect of [the nature and timing of allocations of profits], groups of participating policies are appropriately and equitably distinguished having regard *inter alia* to the terms of the policies, their duration and their relevant pooled experience; and
 - (ii) that the company conducts its affairs, including its new business and investment strategies, with due regard for its financial resources.”

2.21.3 There are also other Guidance Notes that are “recommended practice” (compliance with which does not need to be certified) that refer to PRE. It is noticeable however that the requirements *vis-à-vis* PRE are not prescriptive. This may be recognition that the ICA 1982 provides legitimate flexibility, for example, to accommodate cases where the reasonable expectations of different classes of policyholders might be contradictory.

2.22 Role of the regulator with regard to PRE

2.22.1 IFSD described its role with regard to PRE as follows:

“In the first instance it is the responsibility of the company, with the advice of its [Appointed] Actuary to ensure that it acts in a manner which has regard to PRE.

...

The regulator’s role is not to proactively and routinely review the consistency of companies’ decisions with PRE and it does not automatically receive all the necessary information or have the resources to do so. Hence its approach is to review cases in response to complaints or information included in annual returns and any other information that comes to light that may cast doubt over the ability of a particular company to meet PRE or raises questions as to whether a company has acted (is acting or proposing to act) in a manner which is not consistent with PRE.”

2.23 The Role of the Prudential Regulator

2.23.1 The way in which the role and involvement of the prudential regulator has evolved over recent years is significant to a proper understanding of what the regulator perceived to be its role and how that was changing during the Review Period.

2.23.2 In February 1993, ID consisted of a department of about 24 staff split into four sections, only two of which dealt with life insurance companies. The total resource committed at that time to life insurance companies including composites was eleven. This team was supported by GAD which, at that time, had about eight actuaries (including two trainees), two Chief Actuaries and a high proportion of the time of the Directing Actuary.

2.23.3 The staff numbers responsible for life insurance remained broadly stable up to the beginning of the financial year 1998/9 when authority was received to increase the headcount to 19.

2.23.4 In January 1999, when HMT-ID transferred to the FSA it was joined by the supervisory staff of the Friendly Societies Commission.

2.23.5 We have set out above²⁸ the breakdown of the staff involved in the prudential regulation of life insurance companies at the beginning and at the end of the Review Period. To summarise, on 1 January 1999, the total number of staff involved in the prudential regulation of approximately 200 insurance companies (including the staff at GAD but excluding administration and secretarial staff) was less than 35. By way of comparison, there were approximately 135 staff (excluding administration and secretarial staff) involved in the regulation of approximately 400 authorised UK banks, building societies and UK branches of non-EU institutions.

2.23.6 The change in the level of involvement of the prudential regulator and its relationship with GAD during the 1990s was described to us:

“I noticed a significant change from the time I had last been involved back in 1992, and the time I returned to it in 1998. The division, first in the DTI then in the Treasury, had expanded somewhat and I think considerable improvement had been made in that time in the quantity and quality of staff involved in the supervision. I think there was, by the time I returned...a much better partnership arrangement between the division and GAD. I think...when I was first involved in the insurance division, GAD had been very much the dominant player in life supervision. Partly it was because they had more resource, partly because they had more expertise. And there was really not the opportunity then, certainly on a regular basis, to challenge and to understand properly the views that we were provided with by GAD. I think that there were particular cases where we needed to get involved in some detail, then ...in those cases challenge had happened and had been productive and useful. But for the generality of supervision, it was in effect subcontracted to GAD for the Life industry. But this had changed considerably by the time I returned.”

2.23.7 As regards the role of the regulator, IFSD sees it as one that is:

“limited to monitoring that companies comply with their regulatory obligations and exercising, as appropriate, the powers available to it where a company fails to do so. It is not for the regulator to question the strategy or course of action pursued by a company if it does not bring it into conflict (or significant risk of conflict) with the regulatory requirements.”

2.23.8 Others in IFSD have described their approach as follows:

“I think we start from the proposition that the present financial disclosure regime is prescribed in statute, and the disclosures are made by the companies but with substantial input from and validation from the Appointed Actuary. We have the Appointed Actuary being given statutory duties, having professional duties, and quite effective discipline from his professional body. I think the system as a whole placed a lot of weight on the disclosure regime and the professional competence of the Appointed Actuary and the professional discipline imposed on the Appointed Actuary....A lot of emphasis is placed on the Appointed Actuary. But I don't think that we ever believed that that should be the end of the matter; or

²⁸ Under the sections headed “IFSD” and “GAD”.

that what the Appointed Actuaries said, should go without challenge. But in practicality, I think that challenge was focused where there was some reason to feel that what the Appointed Actuary was doing was questionable or doubtful or whatever.”

“The context of the regulatory framework that we brought with us and we are still operating under prior to N2 is a context which...is one of freedom with disclosure for insurance companies. I think that indicates that the threshold for what you describe as interference is quite high. The basic approach is that there is a legislative framework, and there are regulations under the statute, and companies have to obey... Those regulations in turn are underpinned by actuarial guidance, professional guidance. Provided that framework is adhered to, we would not expect to intervene.....The directors of a company have freedom to decide how to run their business and we have never tried to second-guess that. Our job is to see whether the way they are running their business is consistent with the principles of sound and prudent management in the terms of the Act. And...the criteria of sound and prudent management, are also set out in an annex, as part of the legislation, so they are pretty precise tests and they are quite high tests.”

Conduct of Business Regulation

2.24 Self-Regulating Organisations

- 2.24.1 The FSAct 1986 regulates the conduct of investment business by means of a system of self-regulation. Under the FSAct 1986, no person may carry on investment business unless authorised to do so or exempt²⁹. One of the ways of obtaining authorisation is to join a “self-regulating organisation” (“**SRO**”) which is itself recognised by the “designated agency” under the FSAct 1986 (formerly the Securities and Investments Board (“**SIB**”) and now the FSA). The SROs are financed by their members and supervise their members by reference to their particular rulebooks.
- 2.24.2 The FSAct 1986 provides that, in order to obtain recognition, a SRO must comply, *inter alia*, with the following requirements:
- (a) the SRO must have rules governing the carrying on of investment business by its members such as to afford an adequate level of protection for investors;
 - (b) the SRO must have adequate arrangements and resources for the effective monitoring and enforcement of compliance with its rules;
 - (c) the SRO must have effective arrangements for the investigation of complaints against the SRO or its members; and
 - (d) the SRO must be able and willing to promote and maintain high standards of integrity and fair dealing in the carrying on of investment business and to cooperate, by the sharing of information and otherwise, with the Secretary of State and any other authority, body or person having responsibility for the supervision or regulation of investment business or other financial services³⁰.

²⁹ Section 3 FSAct 1986.

³⁰ Schedule 2 FSAct 1986.

- 2.24.3 Prior to July 1994, the sale of retail investment products was, to a large extent, governed by two SROs:
- (a) the Financial Intermediaries Managers and Brokers Regulatory Association (“**FIMBRA**”); and
 - (b) the Life Assurance and Unit Trust Regulatory Organisation (“**Lautro**”).
- 2.24.4 FIMBRA was responsible for a large number of generally small intermediaries such as independent financial advisers (“**IFAs**”); Lautro’s membership comprised the life insurance companies and the unit trusts. In July 1994, the PIA was recognised as a new SRO with responsibility for retail investment business and the great majority of FIMBRA and Lautro members became members of the PIA.
- 2.24.5 Equitable Life was a member of Lautro and, in July 1994, it joined the PIA.
- 2.24.6 Although the PIA was not recognised as a SRO until July 1994, the fact that it effectively took over from FIMBRA and Lautro and adopted some of the rules of those SROs means that a member of Lautro, such as Equitable Life, would be subject both to the Lautro Rules adopted by PIA, which had been in force since 29 April 1988, the date on which the FSA came into force (referred to as “**A Day**”), and the PIA Rules introduced in July 1994 (although the latter would only apply to activities carried out since July 1994).

2.25 PIA Rules

- 2.25.1 The PIA Rules regulate the activities of dealing, arranging deals, managing and advising. The PIA Rules begin with the ten adopted SIB Principles which, *inter alia*, demand that a firm should:
- (a) observe high standards of integrity and fair dealing;
 - (b) act with due skill, care and diligence;
 - (c) observe high standards of market conduct;
 - (d) seek from customers it advises or for whom it exercises discretion any information about their circumstances and investment objectives to enable it to fulfil its responsibilities to them; and
 - (e) take reasonable steps to give a customer it advises...any information needed to enable him to make a balanced and informed decision.
- 2.25.2 The detailed Rules which follow the Principles require, *inter alia*, that as regards:
- (a) Information given to policyholders: A member must ensure that anything said or written or any document sent, given or shown to an investor or potential investor by the member on its behalf is clear, fair and not misleading either in design or content³¹.
 - (b) Advertisements: A member must ensure that advertisements do not contain statements of fact, promises, forecasts or opinions which are misleading or

³¹ Rule 4.1 We understand that the Lautro Rules did not have an equivalent to this rule. Documents issued between 1988 and 1994 would have to be assessed against the relevant Lautro Rules that were in force at that time.

untrue, or in respect of which the member does not at the time have reasonable grounds for believing them to be true³².

- (c) Recommended transactions: Where a company representative recommends an investor (*inter alia*) to buy a life policy, to vary the terms of an existing life policy, to sell, convert, cancel or surrender a policy or suspend the payment of premiums or to elect to make pension fund withdrawals, the member must ensure that the investor is sent or given a written explanation which, *inter alia*, makes clear why the recommendation has been made (having regard to the investor's circumstances)³³.
- (d) Advice: A company representative, who has dealings with an investor, must give the investor all relevant information and use his best endeavours to enable the investor to understand the nature of any risks involved. In addition, a company representative must use his best endeavours to ensure that he recommends only that contract or those contracts which are suited to that investor, and that there is no other contract available from the member which would secure the investor's objectives more advantageously³⁴.

2.25.3 These Rules only apply to insurance companies to the extent that their business comprises "the marketing of investments and any business which is carried on in connection with the marketing of such investments"³⁵. Marketing is defined as:

- (a) "selling and procuring the sale of packaged products³⁶ and advising persons on such products and on the exercise of the rights conferred by them; and
- (b) activities ancillary to (a) above."

2.25.4 One of the consequences of this definition of marketing is that the Rule relating to information provided to investors only applies to information provided in the context of selling and advising and not to routine administrative information³⁷. This has some relevance in the context of the bonus notices issued by Equitable Life.

2.25.5 The PIA regulatory regime relies heavily on member firms regulating themselves. Under the Rules a member is required to monitor adequately its own staff and representatives to ensure compliance with the Rules and to ensure that the conduct of the staff and representatives is fit and proper. In the event of a material breach of these requirements, the member must take its own action to remedy the breach, to ensure the customer who has suffered loss or damage receives redress, and to inform the PIA³⁸.

2.25.6 As IB-PIA³⁹ told us:

"It is first and foremost the responsibility of regulated firms to comply with their regulatory obligations. A large firm like Equitable has dedicated compliance professionals tasked with ensuring that they meet those obligations. The role of the regulator has been one of checking and monitoring that compliance, but regulators are quite properly not resourced to prevent or identify all breaches."

³² Adopted Lautro Rule L6.6.

³³ Adopted Lautro Rule L3.15.

³⁴ Adopted Lautro Rule, Schedule 2(L8).

³⁵ Table 1C - PIA Rule 1.3.

³⁶ The term 'packaged products' includes any life policy, including a pension contract..

³⁷ See PIA (Commencement and Transitional Provisions) Rules 1994 Table 1C and Glossary.

³⁸ Rule 7.2 PIA Rules.

³⁹ See paragraph 2.27 below.

2.26 PIA's Service Level Agreement

- 2.26.1 Until N2 when the FSMA 2000 comes fully into force, the PIA retains responsibility for continuing to satisfy the criteria for recognition as a SRO under the FSAct 1986. In particular, it retains responsibility for determining (and, if necessary, varying) its policies, Rules and practices as to membership, admission, expulsion, discipline, safeguards for investors and arrangements for taking account of the costs of compliance.
- 2.26.2 In the interim, the PIA has entered into a service level agreement (dated 25 May 1998) with the FSA which took effect on 1 June 1998 (the "PIA SLA"). Under the PIA SLA, the FSA agrees to perform the PIA's function of monitoring compliance with the PIA Rules and to second staff to the PIA for the purpose of carrying out other regulatory functions (including the function of enforcing compliance with the Rules)⁴⁰. As a result, by June 1998, the majority of the staff formerly employed by the PIA had become employees of the FSA.
- 2.26.3 We understand that similar arrangements were made between the FSA and the other SROs. The purpose of these agreements was to devolve as much management responsibility as possible to the FSA whilst leaving the SROs with legal responsibility for their obligations under the FSAct 1986. The agreements were intended to give the SROs the comfort that those obligations would be carried out to the requisite standard.
- 2.26.4 The standard of service required is that the FSA must use its best endeavours to carry out these functions to no less a standard than that which will enable the PIA to be satisfied that it can meet the criteria for recognition as a SRO⁴¹. In addition the PIA Board must be provided with a quarterly written report on the operation of the services provided⁴².
- 2.26.5 A schedule to the PIA SLA sets out detailed performance standards and reporting requirements relating to the different functions of a SRO. In relation to "Supervision", the FSA's general responsibilities are:
- (a) "To monitor the operations of member firms, in accordance with the plans agreed with the PIA Board, to ensure they are complying with PIA regulations and highlight cases requiring enforcement action;
 - (b) To provide advice to member firms and FSA staff on the application of the [FSAct 1986], the PIA Rules and other regulations which apply;
 - (c) Carry out desk based monitoring including reviewing returns from regulated firms...[and] assessing complaints⁴³; and
 - (d) Visit all newly admitted firms within six months of admittance to the PIA."

2.27 Conduct of Business Regulation - The Regulator

- 2.27.1 During the Review Period, the functions of the various SROs for which the FSA is responsible under the service level agreements were carried out by the Investment

⁴⁰ By paragraph 4(1) of Schedule 2 to the FSAct 1986 the PIA is required to have adequate arrangements and resources for the effective monitoring and enforcement of compliance with its rules and by paragraph 4(2) of Schedule 2 to the FSAct 1986 the PIA may provide for its monitoring functions, but not its enforcement functions, to be performed on its behalf (without affecting its responsibilities for such functions) by any other body or person who is able and willing to perform them.

⁴¹ Section 3.1.

⁴² Section 3.6.

⁴³ Schedule 1, part 2.

Business Division of the FSA. This division (known as (“**IBD**”)) was headed by a FSA director and was divided into 4 departments, 3 of which dealt with the business of the SROs for which the FSA was responsible. The department responsible for carrying out the functions of the PIA under the PIA SLA was known as “**IB-PIA**”. The fourth department was “**IB-Policy**” which dealt with the policy development issues relating to the three SROs, including homogenising the different conduct of business rulebooks. IB-Policy also contained a team with some actuarial expertise.

2.27.2 IB-PIA contained 13 supervision teams and responsibility for monitoring member firms was divided among these teams. Each supervision team, headed by a Team Manager, comprised desk and field based officers and was given responsibility for monitoring approximately 350 to 400 firms each including a mixture of product providers (such as Equitable Life) and IFAs. The majority of the time of a field based officer was spent conducting visits to the member firms for which the relevant team was responsible, whilst the desk based officers conducted follow-up work such as responding to queries on the visit report and monitoring the firm’s on-going compliance. The team responsible for Equitable Life was Supervision Team 4.

2.27.3 IB-PIA also contained some “stand-alone” specialist teams including the Supervision Practice Team (“**IB-PIA (Supervision)**”) and the Advertising Supervision Team (“**IB-PIA (Advertising)**”). IB-PIA (Supervision) started life as a helpline answering queries regarding the PIA Rules from both member firms and arising within the FSA. In summer 1999, it ceased to answer external queries (which became the responsibility of the particular supervision teams) but it continued to provide a support service internally. IB-PIA (Advertising) was responsible for monitoring advertising by member firms as well as dealing with complaints about advertising and assisting the field supervision teams where necessary.

2.27.4 IBD and IB-PIA also had access to:

- (a) lawyers within GCD; and
- (b) a department known as Regulatory Enforcement (PIA firms/Bank Investigations) (“**Enforcement**”) within a separate Enforcement Division, headed by a FSA director.

2.28 Conduct of Business Regulation - The Approach

2.28.1 Consistent with the team structure, the way in which the conduct of business regulator managed its responsibilities in respect of life insurance companies during the Review Period falls broadly into the following five areas:

- (a) It subjected new members to an authorisation process;
- (b) It supervised its members on a proactive basis by deploying field based officers to carry out supervision visits to check that the member firm’s processes and the advice being given to investors were compliant. Desk based co-ordinators handled correspondence with the member firms following field supervision visits and dealt with miscellaneous correspondence;
- (c) It monitored advertising and dealt with complaints about advertising within IB-PIA (Advertising);
- (d) It referred consumer complaints to the PIA Ombudsman; and
- (e) It referred alleged Rule breaches to Enforcement for investigation and, if appropriate, disciplinary action. Rule breaches were referred either by the

supervision teams following a visit or came to light as a result of consumer complaints or notifications made by the member firms themselves.

- 2.28.2 The principal way in which the PIA monitored compliance with its Rules during the Review Period was by carrying out supervision visits to its member firms. The number of member firms for which each team was responsible means that visits were not a frequent occurrence. The regularity with which they took place depended on the risk evaluation of each firm but the interval between visits generally varied between 12 months and 36 months.
- 2.28.3 Prior to and during the Review Period, the FSA was moving towards a more flexible approach to supervision visits which was much more risk-based and sought to direct resources to the areas that needed most attention, based on the intelligence obtained in relation to particular firms from various sources including returns, comments in the press and consumers. In other words, IB-PIA was engaged in a constant process of identifying risks and intelligence to determine where to focus its supervisory effort to best effect.
- 2.28.4 IB-PIA described this new approach to us:
- “Post the service level agreement in 1998, in IB-PIA we introduced a new approach to supervision which basically sought to be much more risk-based, risk-focused, more targeted and more resource and cost efficient. What we were trying to do was to get away from a rigid .. sort of approach to an approach that actually tried to direct resources to the areas where it looked as though they were needed.”
- 2.28.5 As a result of this approach, it was intended that IB-PIA should have a closer relationship with the bigger firms or those whose risk profile gave cause for particular concern whilst the smaller firms would only be visited if there was a particular reason to do so.
- 2.28.6 Accordingly, whilst IB-PIA continues to conduct routine “monitoring” visits encompassing a whole range of different areas⁴⁴ (particularly in relation to large firms) there has been a move towards:
- (a) “focused” visits to particular firms concentrating on particular issues rather than on the whole spectrum of the firm’s activities; and
 - (b) “themed” visits to a number of firms concentrating on issues that have application across a particular industry (such as the insurance industry), or which affect consumers of a certain type (such as people who have purchased a particular product).

2.29 The Conduct of Business Regulator - Enforcement

- 2.29.1 As set out above, the PIA SLA provides that the FSA will second staff to the PIA for the purpose of enforcing compliance with the PIA Rules. In practice, this function is carried out by a department known as “Enforcement”.
- 2.29.2 This department investigates particular cases referred to it by IB-PIA and carries out disciplinary action against member firms as required under the PIA SLA (which requires the FSA to investigate cases which suggest significant Rule breaches, investor losses or unwarranted risks to investors and to undertake such disciplinary action as may be required in a fair and timely manner).

⁴⁴Particularly in relation to large firms which the PIA may visit in order to get to know the firm and gather information.

- 2.29.3 The PIA's formal powers of intervention include prohibiting a member from entering into specified types of transactions or soliciting business from persons of a specified kind or carrying on business in a specified manner. These powers may be exercised where it appears necessary or desirable in the interests of investors or where the company has contravened PIA Rules or provisions of the FSAct 1986⁴⁵.
- 2.29.4 The PIA also has a number of disciplinary powers which include issuing reprimand orders, imposing fines and ordering the expulsion of a member from the PIA⁴⁶. These powers can be exercised in respect of a failure to comply with the PIA Rules.
- 2.29.5 However, the exercise of the powers is subject to the following provisos:
- (a) pursuant to provisions of the ICA 1982, the PIA may not intervene in relation to a regulated insurance company on any of those grounds which relate to the ability of the company to meet its liabilities to policyholders; this is a matter for the prudential regulator under the ICA 1982⁴⁷; and
 - (b) before exercising certain powers, (such as restriction of business, restriction on dealing with assets and vesting of assets in a trustee⁴⁸) the PIA must first notify the prudential regulator who has a power of veto⁴⁹.

2.30 The Role of the PIA

- 2.30.1 The following documents describe IB-PIA's objective:
- (a) the Overall Assessment and Co-ordinated Supervisory Programme ("OA-CSP") drafted by IFSD towards the end of 1999:

"to identify instances of investor risk, establish what range of procedures the firm has for its sales force and how robust they subsequently are, together with ensuring that they comply with PIA Rules."
 - (b) A document setting out IB-PIA's objectives for the year 2000/01 indicates that IB-PIA's high level objective is to:

"be proactive in identifying regulatory threats and respond effectively to new regulatory responsibilities" and "continue to develop the regulatory approach to become less mechanical, rigid and reactive; and more judgmental, proactive & relevant for firms' business."
- 2.30.2 The FSA has described the role and approach of the PIA in the following terms:
- (a) "The PIA tradition is at the more passive end of the supervisory process, by which I mean that they have an enormous number of firms. The nature of their supervision, I would say, is much more reactive than proactive - has been traditionally - partly in the face of this huge number of firms, partly in the nature of the staff that they had, but also in the nature of the Board they have had, Lautro and FIMBRA, we are all prisoners of our history. Their history of supervision has been rather reactive rather than proactive. I think the second point to make is that I think they have been comforted in that, by the fact that the compensation scheme exists, the Ombudsman scheme and the compensation

⁴⁵ PIA Rule 9.

⁴⁶ PIA Rule 10.4.3.

⁴⁷ Schedule 10(6) FSAct 1986.

⁴⁸ ss 65-67.

⁴⁹ Schedule 10(6)(3) FSAct 1986.

schemes exist to provide ex-post protection, a safety net and clearly, if you have that, the importance of taking an early proactive decision is less if- as far as the consumer is concerned - any detriment can be addressed after the event.”

- (b) “A key point is that a typical field team is responsible for supervising perhaps 350 - 400 firms. [The SRO approach] puts the responsibility for delivering compliance clearly on the regulated firms. They (in particular larger product provider firms) have specialist resources and processes to ensure that they meet the required standards. The regulator’s job is to check the application of those processes in practice and to handle problems it identifies through its visit or other supervisory processes, or through other intelligence.”
- (c) “Where we are moving to, I think, is...an environment whereby we actually spend more time with the bigger players and try and get more proactive with them. So the relationship would be not just with the compliance people, where it predominantly is now, but also with the chief executive, marketing director ... So we understand much better, we get closer to the business strategies of these firms, we understand what makes them tick better and then we can assess what risk management needs to be around that sort of fundamental business value and strategy and make sure the risk management people in the firm, compliance people are dealing with that. The intention there being that you get to the heart, you understand what is going on earlier and you can nip issues in the bud before they become problems.”

2.31 The PIA Ombudsman and Complaints

- 2.31.1 Under the PIA Rules, member firms have an obligation to establish and maintain a proper procedure for handling complaints and a firm applying for membership of the PIA will not be admitted unless its complaints system complies with the framework set out in the PIA Rules. The firm is also required to explain to the complainant that if he or she is not happy with the outcome of the firm’s investigation, the complaint may be referred to the PIA Ombudsman and is obliged to co-operate with the PIA Ombudsman in relation to any on-going investigation and to comply promptly with any awards made by the PIA Ombudsman in due course.
- 2.31.2 The PIA Ombudsman is a subsidiary of the PIA and its Terms of Reference are issued by the Board of the PIA in accordance with the PIA’s Articles of Association. Under the Terms of Reference, the PIA Ombudsman has jurisdiction to resolve complaints made against firms regulated by the PIA. The Terms of Reference also cover procedure, settlements, awards and recommendations, limitations and test cases. On receipt of a complaint, the PIA Ombudsman must investigate and facilitate the satisfaction, settlement or withdrawal of the complaint by whatever process seems expedient.
- 2.31.3 This service is available to consumers without charge. However, the complainant is not bound by the PIA Ombudsman’s determination and may subsequently choose to bring court proceedings against the particular firm. In addition, the PIA Ombudsman may relinquish jurisdiction over a complaint if the firm which is the subject of the complaint serves a notice containing a statement that the complaint involves an issue which may have important consequences for firms generally, or an important, or novel, point of law. This occurred at the beginning of the Review Period when Equitable Life decided to initiate the Court proceedings to test the lawfulness of its terminal bonus practice.
- 2.31.4 Any complaints against firms received by the PIA or IB-PIA are simply referred to the PIA Ombudsman, unless there is a particular issue relating to the firm’s practices that needs to be considered by the PIA or there are compliance implications.

- 2.31.5 Under the Terms of Reference, the PIA Ombudsman is required to submit an annual report to the PIA Board containing a general review of its activities and to inform the PIA of any failure by a firm to provide information to the PIA Ombudsman during the course of an investigation. In addition to this formal communication there is also some informal contact between IB-PIA and the PIA Ombudsman but, essentially, IB-PIA relies on the PIA Ombudsman to bring to its attention particular complaints or a series of complaints in relation to a particular issue.⁵⁰ We understand that IB-PIA regards the PIA Ombudsman as a convenient source of information in relation to the activities of member firms and that information from the PIA Ombudsman can trigger action by IB-PIA. For example, if IB-PIA became aware of a large number of complaints in relation to a particular issue, a “focused” visit or “themed” visit might be triggered. Information about complaints would also be relevant to the assessment of the risk rating of a particular firm and its compliance with the PIA Rules.

Interaction: Prudential and Conduct of Business Regulation

2.32 Introduction

- 2.32.1 The jurisdictional boundaries between prudential and conduct of investment business regulators are prescribed by the ICA 1982 and the FSAct 1986. Certain of the provisions of the ICA 1982 are disapplied in respect of insurance contracts which constitute investment business and to which the FSAct 1986 applies⁵¹. Similarly, the application of some of the provisions of the FSAct 1986 is restricted in the case of insurance companies in recognition of the fact that these companies are subject to certain provisions of the ICA 1982⁵².
- 2.32.2 The FSAct 1986 provides that, where an insurance company is regulated by a SRO (such as the PIA), that organisation must take proper account of the regulation applied under the ICA 1982⁵³. The only aspects of an insurance company’s business which are subject to conduct of business Rules are:
- (a) procuring proposals for policies which constitute investment business and advising persons on such policies and the exercise of the rights conferred by them;
 - (b) managing the investments of pension funds, procuring persons to enter into contracts for the management of such investments and advising persons on such contracts and the exercise of the rights conferred by them; and
 - (c) matters incidental to (a) and (b) above⁵⁴.
- 2.32.3 The regulations under section 72 of the ICA 1982 (insurance advertisements) are disapplied to the extent that any advertisement relates to a contract of insurance the rights under which constitute an investment for the purpose of the FSAct 1986. Similarly, the requirements under sections 74 to 77 of the ICA 1982 are disapplied in respect of long-term insurance business which is investment business (intermediaries in insurance transactions, statutory notice by insurer in relation to long-term policy,

⁵⁰ IB-PIA (Supervision) did provide occasional support to the PIA Ombudsman in relation to PIA and Lautro Rule interpretation, complainants that the PIA Ombudsman could not help and where the complainant wanted to discuss issues with somebody else.

⁵¹ Sections 72, 74 - 77 ICA 1982 are disapplied in respect of long-term insurance contracts which are investment business Schedule 10(5) FSAct 1986.

⁵² Sections 65 -67 - see Schedule 10 paragraphs 6(3) and (4) FSAct 1986.

⁵³ Schedule 10(3).

⁵⁴ Schedule 10(4).

right to withdraw). This is in recognition of the fact that the conduct of business Rules in respect of this business which apply are those prescribed by the FSAct 1986.

2.32.4 As outlined above, the enforcement powers under the FSAct 1986 are also modified in respect of regulated insurance companies to ensure that decisions which impact on the prudential aspects of an insurance company's business are referred to the prudential regulator. Powers of intervention under the FSAct 1986 may not be exercised for reasons relating to the ability of an insurance company to meet its liabilities to policyholders or potential policyholders (as this is a matter for prudential regulation under the ICA 1982). The PIA may not exercise powers under sections 65 (restriction of business), 66 (restriction on dealing with assets) and 67 (vesting of assets in trustee) if HMT has served a notice directing it not to do so. Similarly, where a SRO (such as PIA) proposes to exercise any powers corresponding to those above (for example, restricting the scope of business an insurance company can carry out under its rules) it must notify its intention to HMT and HMT may direct it not to do so.

2.33 Co-ordination of Work

2.33.1 Prior to 1 January 1999 the two regulators were, and operated as, entirely separate entities and there was no formal or structured channel of communication between them.

2.33.2 After 1 January 1999, reporting arrangements were put in place so as to encourage bilateral interaction:

- (a) "ChairCo" Meetings: These were attended by the two Managing Directors of the FSA, the Chief Operating Officer and Howard Davies. The meetings concentrated primarily on management issues such as staffing and cost control. Quarterly Reports from each of the divisions of the FSA (including IBD and IFSD) were directed to Chairco.
- (b) "ExCo" (later "DirCo") Meetings: These were attended by directors of the FSA including the directors of IBD, IFSD and Enforcement. They were held on a weekly basis. The purpose of these meetings was to discuss key policy development and broad regulatory issues.
- (c) Firms and Markets Committee ("FMC"): This was established in mid-2000 and met weekly. It was chaired by Howard Davies (or one of the Managing Directors, if he was not available) and was principally attended by members of ChairCo and those directors with direct regulatory responsibility. It focused on firm and market related issues.
- (d) Bilateral Liaison Meetings: These were held bi-monthly between IFSD and IB-PIA and were instituted in early 1999. Typically, these were attended by representatives from group and senior management and by staff who had firm-specific issues to raise. The meetings would involve discussion on current regulatory issues, industry developments and specific issues on firms.
- (e) Financial Supervision and Management meetings: (chaired by Michael Foot) which "would concentrate on management type issues - but it was a forum for people to mention hot issues in their area".
- (f) Supervisory Co-ordination Meetings were set up as a pilot scheme to allow IB-PIA staff to get a better understanding of how IFSD staff operated, the issues they considered and the sort of intelligence it held on different firms.

2.34 Lead Supervision

- 2.34.1 In addition, the creation of a single national regulator gave rise to the opportunity to develop a formal system of co-ordination between the different regulators. The system that was adopted by the FSA from banking supervision practice was known as “lead supervision”. Essentially, lead supervision is intended to promote the sharing of information between and co-ordination of all the different regulators which supervise a particular entity. This is facilitated by the appointment of one of the regulatory bodies to be a “lead supervisor”. The lead supervisor is chosen according to the “predominant business test”. Since the business of Equitable Life is predominantly insurance-based, the lead supervisor for Equitable Life was IFSD.
- 2.34.2 Lead supervision was implemented in two stages. The main objective of the first stage was to improve information flows amongst all the regulators who supervise a particular entity. The second stage aimed to build the responsibilities of the lead supervisor by assigning to it three key responsibilities:
- (a) acting as a central point of supervisory contact;
 - (b) maintaining an overall assessment of the group in those areas which are most likely to affect the risks that the group as a whole faces; and
 - (c) co-ordinating the preparation and implementation of a prioritised supervisory programme drawn up in co-operation with all the group’s FSA supervisors.
- 2.34.3 In practice, the lead supervisor co-ordinated the preparation of a OA-CSP which set out the risk rating and the action planned by each regulatory body in respect of the particular entity, including the timing of any visits.
- 2.34.4 The group of individuals with responsibility for a particular entity, comprising one person from each regulator, was known as the “college” and college meetings were instituted as part of the implementation of lead supervision. The purpose of the college meetings was to enable the college members to gain an understanding of the way each division worked and to build working relationships within the FSA to exchange information regarding the particular entity and to co-ordinate the scheduling of visits. The meetings also provided an opportunity for members to discuss particular issues that would influence the regulator’s perception of a firm and how it should be regulated.
- 2.34.5 The first lead supervision training for FSA staff took place in early March 1999 and this laid the foundations for an increased level of co-ordination between IB-PIA and IFSD. The training involved information about how to find counterparts in other regulators, the different regulatory systems, the general basis for exchanging information and the purpose of lead supervision. A list of the individuals assigned to particular entities from each of the regulatory bodies was generated enabling direct liaison between the appropriate individuals across the FSA departments. In June 1999, IFSD and IB-PIA agreed to pilot supervisory co-operation in respect of 11 firms including Equitable Life.