

**APPENDIX A**  
**OUTLINE CHRONOLOGY**

1762	Equitable Life founded, as the 'Society for Equitable Assurances on Lives and Survivorships'.
1848	Founding of the Institute of Actuaries.
1856	Founding of the Faculty of Actuaries.
1870	Life Assurance Act 1870 enacted as a measure to protect policyholders, after an unprecedented level of insolvency of life insurers. Gave responsibility to the Board of Trade.
1913	Equitable Life started to sell pensions.
April 1951	Establishment of Millard Tucker Committee on Taxation of Retirement Benefits.  Roy Ranson joins Equitable Life.
1953	Publication of 'a(55) Tables for Annuitants (CMI)', providing a new actuarial approach to annuitants' mortality.
February 1954	Publication of the Tucker Committee report into the 'Taxation Treatment of Provisions for Retirement'.
1956	Finance Act 1956, extending the right to self-employed people to tax relief on retirement provision. (Subsequently consolidated into the Income and Corporation Taxes Acts of 1970 and of 1988.)
1957	Equitable Life sold its first retirement annuity (RAP), based on 'a(55)' mortality tables and containing 'Rates of Guaranteed Annuity'. A form of final bonus was applied to retirement annuities to align the annuity at maturity to that which could be obtained from current annuity rates.
April 1963	Equitable's last quinquennial (5-yearly) bonus declaration.
1967	Maurice Ogborn became the Society's general manager and actuary in succession to Henry Tappenden.
1970	Finance Act 1970: signalled replacement of 'old code' tax approval of pensions business by 5 April 1980 and heralded the end of the Federated Superannuation Scheme for Universities (FSSU).
1971	Finance Act permitted partial commutation of RAPs for tax-free cash.  Equitable increased the rate of GIR to 3% per annum.
15 May 1991	Management agreement to proceed with introduction of with profits policies with no reversionary bonus.
October 1972	Ogborn retired as the Society's general manager and actuary; replaced by Barrie Sherlock. Ranson promoted to deputy actuary.
1973	Insurance Companies Amendment Act 1973: introduced the prospect of failure to meet the 'reasonable expectations' of policyholders and potential policyholders as a trigger for regulatory action.
April 1973	Equitable introduced a non-guaranteed terminal (later final) bonus. 'Three-call' system of bonus initiated.

1974	Insurance Companies Act 1974 consolidated existing legislation. Section 15 defined the statutory role of the appointed actuary. Sherlock became the Society's first appointed actuary.
August 1974	Product Investigation Team (PIT) set up, under the chairmanship of Roy Ranson.
1 May 1975	Publication of first edition of Institute and Faculty of Actuaries' guidance note 1 (GN1), 'Actuaries and long-term business'. Limited actuaries' freedom to differ from their fellow actuaries; crucial to public (and government) confidence in appointed actuaries and protection of policyholders' interests.
October 1975	Equitable increased the guaranteed rate of interest (GIR) to 3½% per annum and the interest rate in possession to 7%. Originally these had been 2½% p.a. and 4% respectively.
1978	Section 22 of the Finance Act allowed an open market option to be provided, so a pension policyholder could purchase an annuity from a different office.
5 March 1979	Adoption of 1 <sup>st</sup> Life Directive, which inter alia permitted the use of future profits implicit items in calculating regulatory solvency.
20 December 1990	First application by Ranson for use of future profits implicit item.
1981	Insurance Companies Act 1981: implemented 1 <sup>st</sup> Life Directive.
1 January 1982	Ranson promoted to joint actuary with Sherlock, and became the Society's appointed actuary in succession to Sherlock.
1982	Insurance Companies Act 1982 consolidated Insurance Companies Acts 1974 and 1981. This is the main statute governing prudential regulation of the Society during the period covered by this report.
May 1982	John Caldecott retired as the Society's president; replaced by David Murison.
Autumn 1982	Current annuity rates fell below guaranteed annuity rates for a short time during autumn of this year.
1 October 1982	Insurance Companies Regulations 1981 (SI 1981/1654), set out rules for valuing liabilities.
1983	Approach to meeting cost of annuity guarantees out of terminal bonus was decided upon by the Society's management. This approach developed into the differential terminal bonus policy in 1993.
1 October 1983	Publication of first edition of Institute and Faculty of Actuaries' guidance note 8 (GN8), 'Additional guidance for appointed actuaries and appropriate actuaries'.
25 January 1984	'Three-call' bonus system abandoned.
15 March 1984	Insurance Companies (Accounts and Statements) Regulations 1983 (SI 1983/1611)
5 October 1984	Regulatory guidance issued for applications for use of future profits implicit items.
January 1985	Ranson appointed to the Society's board as an executive director.
1986	Publication by Prof. Alan Wilkie of 'A Stochastic investment model for actuarial use'.

May 1986	David Murison retired as the Society's president; replaced by Professor Roland Smith.
December 1986	Association of British Insurers (ABI) published first 'Statement of Recommended Practice on Accounting for Insurance Business' (SORP).
1987	Equitable's last triennial (3-yearly) bonus declaration.
19 October 1987	Black Monday. Largest one-day fall in the stock market since October 1929.
29 April 1988	The Financial Services Act 1986 came into force (referred to as 'A Day'). The Life Assurance and Unit Trusts Regulatory Organisation (LAUTRO) became a self-regulating organisation (SRO), answerable to the Securities and Investments Board (SIB) for conduct of business regulation of life insurance companies, including Equitable Life.
1 July 1988	Personal Pensions replaced RAPs for new business.
1989	Establishment by Equitable of an internal new business loan to capitalise the acquisition cost of new business over the life of each policy.
20 March 1989	<i>With Profits Without Mystery</i> presented by Roy Ranson and Chris Headdon to the Institute of Actuaries in London.
April 1989	Equitable policyholders' annual statements changed to show rolled-up policy value to their policies, including non-guaranteed final bonus.
19 February 1990	<i>With Profits Without Mystery</i> presented by Headdon to the Faculty of Actuaries in Edinburgh.
May 1990	ABI published second SORP.
August 1990	Responsibility for developing accounting standards passed from the Accounting Standards Council (ASC) to the Accounting Standards Board (ASB).
20 December 1990	First application by Ranson for use of future profits implicit item.
Year end 1990	Society introduced 1¼% differential for first time into the regulatory liability valuation between the gross bonus rate assumed and the interest rate used to discount liabilities.
30 June 1991	Sherlock retired as the Society's general manager and actuary.
1 July 1991	Ranson became the Society's managing director and actuary, whilst continuing to hold the position of appointed actuary.
October 1991	The Auditing Practice Committee (APC) issued auditing guidance 311 (AG 311), 'Life Insurers in the United Kingdom', providing guidance for audit of life insurers.
16 September 1992	Black Wednesday: sterling left the European Exchange Rate Mechanism.
6 November 1992	First indication by Ranson to GAD of the use of a quasi-zillmer adjustment in the 1991 returns.
December 1992	Publication of the Cadbury Report, 'The Financial Aspects of Corporate Governance'.
7 July 1993	Consideration of use of subordinated loan capital first raised by Ranson with GAD.

October 1993	Guaranteed annuity rates “in the money” for a short time.
22 December 1993	Equitable Board adopted differential terminal bonus policy in amended notes to the 1992 declaration.
24 January 1994	Equitable’s Audit committee established.
8 February 1994	The Systems and Controls Review Group (SCRG) set up.
9 February 1994	Equitable bonus valuation meeting held, at which introduction of DTBP was confirmed for 1993.
May 1994	Roland Smith retired as president; replaced by John Sclater.
1 July 1994	Improved rules introduced for the sale and marketing of investment products. The Personal Investment Authority (PIA) replaced LAUTRO as conduct of business regulator for insurance companies.
	The Insurance Companies (Third Insurance Directives) Regulations 1994 came into force.
	Insurance Companies Regulations 1984 (SI 1984/1516), set out further rules for valuing liabilities.
1 December 1994	Prudential Guidance Note 1994/6 issued by DTI.
Year end 1994	First use of future profits implicit item in form 9 of the 1994 return.
April 1995	Guaranteed annuity rates “in the money”. The GAR liability became increasingly onerous for the Society from this point.
17 July 1995	Publication of the Greenbury Report on directors' remuneration.
January 1996	The Securities Risks and Controls Group (SRCG) established by Equitable.
1 June 1996	GIR for new Equitable pension business sold on or after this date reduced to 0%.
November 1996	SRCG renamed the ‘Internal Controls Review Team’ (ICRT).
23 December 1996	Insurance Companies (Accounts and Statements) Regulations 1996 (SI 1996/943)
20 May 1997	Chancellor of the Exchequer announced reform of financial services regulation and future creation of a single regulator.
18 July 1997	Society issued £350m of subordinated debt.
31 July 1997	Ranson retired as managing director and appointed actuary. Replaced as managing director by Alan Nash and as appointed actuary by Chris Headdon.
19 August 1997	Application granted for the issue of £350m of subordinated loan capital.
October 1997	Securities and Investment Board (SIB) changed its name to the Financial Services Authority (FSA).
Year end 1997	Interest rate differential eliminated from liability valuation for first year since introduced for 1990.

January 1998	Publication of the Hampel Report on corporate governance. ICRT renamed the 'Risk Management Group' (RMG).
5 January 1998	Responsibility for prudential supervision of insurance companies transferred from the Department for Trade and Industry (DTI) to HM Treasury.
12 March 1998	No entitlement to declared (reversionary) bonus for new business sold after this date. All bonus to be in the form of final bonus, added on termination or withdrawal.
1 June 1998	Transfer of responsibility for banking supervision to FSA under the Bank of England Act 1998 effective from this date, which was referred to within the industry as 'N1'.
July 1998	First complaints received by Personal Investment Authority Ombudsman about policies with guaranteed annuities.
August 1998	Equitable's financial position and conduct of its with-profits business came under close scrutiny in the press.
10 September 1998	Publication of Law Commission Consultation Paper, 'Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties'.
December 1998	ABI published third SORP.
1 January 1999	HM Treasury's role as prudential insurance regulator delegated to FSA from this date.
13 January 1999	Originating Summons issued by Equitable to Alan Hyman.
1 April 1999	Date of Headdon's 'side-letter' to the financial reinsurance agreement.
August 1999	The Auditing Practice Board (APB) issued practice note PN 20: 'The Audit of Insurers in the United Kingdom', superseding AG 311.
16 September 1999	Equitable Life won case in the High Court. Mr Hyman was granted leave to appeal.
11 October 1999	Date on which Headdon signed the financial reinsurance treaty.
20 January 2000	Equitable Life lost case in the Court of Appeal; but decided to appeal to the House of Lords.
February 2000	SCRG disbanded by equitable to make way for the new business risk department. RMG evolved into the business risk management group (BRMG). Both replaced by the internal audit function.
May 2000	Publication of 'The Combined Code: Principles of Good Governance and Code of Best Practice'.
14 June 2000	Financial Services and Markets Act 2000 received Royal Assent.
20 July 2000	Equitable Life lost appeal before the House of Lords. Society put itself up for sale.
2 August 2000	Decision announced that no growth would be allocated on with-profits policies for the first seven months of 2000.
23 November 2000	Realisation by GAD of Equitable's use of quasi-Zillmer adjustment.

- 8 December 2000 Equitable closed to new business. Nash resigned as managing director. Headdon nominated chief executive and appointed actuary.
- 28 February 2001 Sclater resigned as president. Vanni Treves became chairman.
- 1 March 2001 Headdon resigned as chief executive and appointed actuary; replaced by Charles Thomson as chief executive and by Peter Nowell as appointed actuary.
- 6 March 2001 Publication of 'Institutional Investment in the United Kingdom: A Review', by Paul Myners.
- 29/30 March 2001 Publication by the House of Commons Treasury Select Committee of 'Equitable Life and the Life Assurance Industry: an Interim Report'.
- June 2001 Publication of the final report of the Company Law Review Steering Group, 'Modern Company Law for a Competitive Economy'.
- 16 July 2001 Equitable announced a 16% cut in the value of with-profits pension policies and that, with the exception of contractual guarantees, no growth would be allocated for the period from 1 January to 30 June 2001.
- 31 August 2001 This inquiry launched by the Economic Secretary to the Treasury. Operative date for the terms of reference.
- September 2001 Publication of the Corley Report into Equitable Life.
- 17 October 2001 Publication of the Baird Report into regulatory handling of Equitable Life between 1 January 1999 and 8 December 2000.
- 1 December 2001 Financial Services & Markets Act 2000 came into force, making the FSA the single regulator for financial services in the UK. From this date, the FSA replaced the PIA as COB regulator and assumed formal responsibility for prudential insurance regulation. This date was also known as 'N2'.

**APPENDIX B****GLOSSARY**

ABI	Association of British Insurers
Actuary's certificate	A certificate provided by the appointed actuary of a life office in terms of Schedule 6 to the Insurance Companies (Accounts and Statements) Regulations 1996, and predecessor provisions.
Admissible assets	Asset that can be taken into account for the purposes of a firm's solvency requirements valued in terms of applicable regulations.
AVC	Additional Voluntary Contribution: a payment on a voluntary basis into an employer's occupational pension scheme.
BIA	British Insurers' Association (which became the ABI).
Companies Act accounts	Statutory accounts prepared in accordance with the Companies Act accounting requirements, currently in terms of the Companies Act 1985.
Compromise Scheme	A scheme for compromise between a company and its creditors, or any class of them, under section 425 of the Companies Act 1985. The proposed details of the Society's compromise scheme were published in Autumn 2001 and received sanction from the courts the following Spring.
Conduct of Business regulation	Regulation relating to the sales processes of the company.
Corley	Report of the Corley Committee of Inquiry regarding The Equitable Life Assurance Society (published by the Faculty and Institute of Actuaries in September 2001).
DTI	Department of Trade and Industry. Formerly Board of Trade and Department for Trade. Responsibility for regulation rested with the Board of Trade up to 1970, the Department of Trade & Industry 1970-74, the Department of Trade 1974-83, the Department of Trade & Industry from 1983 to transfer of functions to HM Treasury on 1 January 1999.  Website <a href="http://www.dti.gov.uk">http://www.dti.gov.uk</a> .
Deferred Acquisition Costs	Costs of writing insurance business relating to contracts in-force at the balance sheet date, which are carried forward from one accounting period to subsequent accounting periods in the expectation that they will be recoverable out of future margins within insurance contracts after providing for contractual liabilities.
Deferred Annuity	An annuity that will provide a policyholder with regular income over the policyholder's lifetime after a specified age has been reached.
Director's Certificate	A certificate provided by the directors of a life office in terms of Schedule 6 to the Insurance Companies (Accounts and Statements) Regulations 1996, and predecessor provisions containing the directors' confirmation that specified matters comply with the rules as stated in the 1994 regulations.
DTBP	Differential Terminal Bonus Policy
ELAS	Acronym for the Equitable Life Assurance Society.  Website: <a href="http://www.equitable.co.uk/">http://www.equitable.co.uk/</a>

Estate or Free Estate	In insurance industry parlance, the balance of admissible assets over mathematical reserves held back from bonus distribution to with profits policyholders as a buffer against major fluctuations in investment values or in underwriting experience or in central costs of administration.
Faculty of Actuaries	The governing body for Scottish actuaries, founded in 1856 and incorporated by Royal Charter in 1858. It shares its Board of Management with the Institute of Actuaries supervising the education and development of actuaries and issuing Guidance and Practice notes on various issues. Designatory letters = AFA (Associate) and FFA (Fellow).  Website: <a href="http://www.actuaries.org.uk/">http://www.actuaries.org.uk/</a>
Final annuity adjustment	An Equitable Life phrase from the early 1960s denoting the granting of a supplement to a deferred annuity contract at maturity so that the amount of annuity received by applying the GAR to the policy proceeds was the same as would have been obtained if the current annuity rate had been applied to the proceeds before adding the bonus.
First Life Directive	Council directive of 5 March 1979 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct life insurance. (No.79/267/EEC)
Form 9	A summary of the general business and long-term business assets allocated towards the relevant required minimum margin thus showing the company's regulatory solvency position. The form 9 position is derived from the other forms that make up the full regulatory return, other than for implicit items of future profit.
FSA	Financial Services Authority. Previously the Securities & Investments Board, the Authority was the agency responsible for regulation of some financial services (and recognition of self-regulating organisations) under the Financial Services Act 1986. It was renamed in October 1997 as part of process of creating single financial services regulator. It took over banking regulation in June 1988 and assumed delegated responsibility for insurance regulation in January 1999. Since 1 December 2001 FSA has had statutory responsibility for financial services regulation under the provisions of the Financial Services and Markets Act 2000.  Website: <a href="http://www.fsa.gov.uk/">http://www.fsa.gov.uk/</a>
FSMA	The Financial Services and Markets Act 2000
Future profit implicit item	Item that can be counted, within certain limits, towards meeting a company's RMM in respect of its long-term business at the discretion of the regulator. This item allows insurers to take credit for margins in mathematical reserves to the extent that they are expected to emerge in the future from in-force business. See chapter 7.
GAD	Government Actuaries Department – central government body employing all actuaries in the government service, amongst whose duties has been the review of regulatory returns and actuarial advice to the prudential regulators for insurance (DTI, HM Treasury and FSA).  Website: <a href="http://www.gad.gov.uk/">http://www.gad.gov.uk/</a>

GAR	Guaranteed Annuity Rate –See the foreword paragraph 17.
GIR	Guaranteed Interest Rate (or Guaranteed Investment Return) – an amount by which basic benefits are guaranteed to increase each year before the addition of reversionary (declared) bonus. Originally set by the Society at 2½% per annum on its RAP business, this was raised to 3%, and then in October 1975 to 3½% per annum. Removed from new pension policies taken out after 30 June 1996.
GMT	General Management Team. See chapter 9
GN1	Guidance Note 1: Actuaries and Long-Term Insurance Business. Issued by the Institute and Faculty of Actuaries.
GN2	Guidance Note 2: Financial Condition Reports. Issued by the Institute and Faculty of Actuaries.
GN8	Guidance Note 8: Additional Guidance for Appointed Actuaries. Issued by the Institute and Faculty of Actuaries.
Government Actuary	Head of GAD
Hidden Reserves	Reserves resulting from the underestimation of assets and overestimation of liabilities (other than mathematical reserves)
HMT	Her Majesty's Treasury. Assumed policy responsibility for financial services from 1992 and responsibility for insurance regulation from 1998.  <a href="http://www.hm-treasury.gov.uk">http://www.hm-treasury.gov.uk</a>
IB-PIA	Personal Investment Authority Insurance Business Division, a division of FSA that undertook regulatory responsibilities for PIA pending creation of the single financial services regulator under the Financial Services & Markets Act 2000.
IFA	Independent Financial Adviser
IMRO	The Investment Managers' Regulatory Organisation.
Institute of Actuaries	The governing body for English actuaries, founded in 1848 and incorporated by Royal Charter in 1884. It shares its Board of Management with the Faculty of Actuaries supervising the education and development of actuaries and issuing Guidance and Practice notes on various issues. Designatory letters = AIA (Associate) and FIA (Fellow)  Website: <a href="http://www.actuaries.org.uk/">http://www.actuaries.org.uk/</a>
Insurance Companies Regulations	Refers to the Insurance Companies Regulations 1994 and predecessor editions.
Interest rate differential	Differential between assumed gross bonus rate and rate for discounting liabilities introduced by Society into its liability valuation from 1990 to 1997. See chapter 7.
Key Features / Facts Document	Information about a policy contract which is required to be in format specified by the regulator
LAUTRO	Life Assurance and Unit Trusts Regulatory Organisation...
MVA or MVR	Market Value Adjustment or Market Value Reduction applied by Equitable on non-contractual claims to reduce policy values.
Mathematical reserves	Insurance fund liabilities for regulatory purposes calculated with reference to the present value of future expectations of income, expense and investment yield.

Maturity	The point, other than on death, from which policy benefits become contractually payable.
Maxwellisation	Process by which those subject to potential criticism by an inquiry are given an opportunity to make representations.
Mortality Table	A listings by age of the probable death rates of a similar group of people, based on actual past experience. The table will show the assumed number of people left alive at each subsequent age from a given age group.
Mutual Life Office	A life insurance company owned by its policyholders rather than by shareholders. Participating policyholders receive a share of the profits earned by the office, in the form of bonuses applied to their respective policies.
New Business Strain	Requirement for capital to support the writing of new business.
Non-GAR	Any Equitable with-profits contract that did not contain an annuity guarantee or GAR. Upon vesting, the annuitant receives an annual income derived by using the insurer's current annuity rate, which will be derived by reference to underlying market rates for fixed interest securities.
Orphan assets	In general terms, assets held by a financial institution that are not immediately attributable to a depositor or investor. In pension and life funds the term is used loosely to describe those assets held in excess of the expected liabilities (see Estate).
PIA Ombudsman	The independent complaints handling agency for resolving complaints by investors against firms which were regulated by the PIA
PIA	Personal Investment Authority. A self-regulating organisation recognised by the SIB (later FSA) under the Financial Services Act 1986.
PIA Review	A review on the mis-selling of personal pensions for the period 29 April 1988 to 30 June 1994. The start date was the date when FSA 1986 came into effect (and when membership of a company pension scheme was no longer a condition of employment). 30th June 1994 was the day before the revised and tighter conduct of business rules came into force, when the PIA took over responsibility for CoB regulation; from LAUTRO of insurance companies and from FIMBRA of financial advisers. Also known as the SIB review and the Pensions Review
PPFM	Principles and Practice of Financial Management. Document describing policy for management of with-profits business which FSA now requires life offices to prepare.
Policy Document	A document that sets out the terms and conditions of the insurance contract.
Policyholder	The person who is the legal holder of the policy for securing the contract with the insurance company
Policy Value	The full current value of the policy. The value of a participating policy will include the value of bonuses assuming the policy will continue until maturity has been reached. This is not the same as the cash value

PRE	Policyholders Reasonable Expectations. Introduced in the Insurance Companies (Amendment) Act 1973. Powers were bestowed to protect policyholders against the risk of a company's inability to fulfil the reasonable expectations of a policyholder. PRE is the ground for use of the residual power of intervention under section 45 of ICA 1982. See especially chapter 13.
PIT	Product Investigation Team comprising senior executives of Equitable. Instigated in August 1974 to review existing products, examine new products and assess their suitability as potential ELAS products and to design and adapt new and existing products
Prudential regulation	Regulation concerning itself with the overall solvency of the company
PSB	Prudential Sourcebook. FSA's rules and guidance effective from January 1 2004.
Quasi-Zillmer Adjustment	A modified Zillmerisation technique adopted by the Society with respect to their regulatory valuation.
Rectification Scheme	Scheme for compensating former policyholders introduced by the Society in response to the <i>Hyman</i> decision.
Resilience Test	A requirement for prudent provision to be made against the effects of possible future changes in the value of assets on the adequacy of these assets to meet liabilities. The reserves required to satisfy the resilience test are known as the resilience reserves.
RMM	Required Minimum Margin of Solvency. See chapter 10, paragraph 6.
RSP	Recurrent Single Premium. Refers to contracts that did not require regular policy premiums to be paid. Accounted for bulk of Society's business for much of the period covered by the inquiry.
Regulatory or Required Solvency	The financial status of an insurance company whose admissible assets exceed their liabilities including mathematical reserves. The difference is called the margin of solvency and must be greater than the greater of the "required minimum margin of solvency" and the "guarantee fund".
Reinsurance	An arrangement with another insurer (a reinsurance company) whereby risks are shared for an agreed fee. It enables insurance companies to accept large or unusual risks and reduce the effects of variations in claims experience from year to year.
SCRG	Systems and Controls Review Group established in 1993. See chapter 9
Scrutiny	Refers to examination of Society' annual regulatory returns to the DTI, HMT and subsequently FSA. Under the terms of the service level agreement that GAD entered into with each of these bodies in turn, a report would be submitted commenting on new business written, the minimum solvency cover required, movement in the mathematical liabilities etc.
Section 68	Section 68 of the Insurance Companies Act 1982 under which HMT may by order direct that all or any of the provisions to which the section applies shall not apply to the company or shall apply to it with such modifications as may be specified in the order.

Schedule 4	A subset of forms within the regulatory return containing detailed actuarial information on long-term business. The appointed actuary is also required to give information to demonstrate compliance with the Third Life Directive.
SIB	Securities and Investments Board (became FSA in October 1997).
SLA	Service Level Agreement. SLAs were signed between DTI and GAD in 1984 and 1995, and then between HMT, FSA and GAD when FSA assumed delegated responsibility for insurance regulation in 1999.
SORP	Statement of Recognised Practice. An industry standard of accounting presentation of financial statements.
SLC	Subordinated Loan Capital. A loan which in the event of the winding up of the company is repayable by the company only after all other liabilities of the company (other than those in respect of share capital and amounts which the company may be liable to pay under section 59(4) of the Companies Act 1981) have been paid in full.
SRCG	Securities Risks and Controls Group; later renamed to ICRT – Equitable Internal Controls Review Team.
SSAP	Standard Statement of Accounting Practice.
Third Life Directive	The Council Directive of 18 June 1992 on the coordination of laws etc, and amending Directives 73/239/EEC and 88/357/EEC (No.92/49/EEC)
Wednesbury reasonableness	Test applied by the courts in judicial review of discharge of official functions derived from <i>Associated Provincial Picture Houses Ltd v Wednesbury Corporation</i> [1948] 1 KB 223, CA. In brief the courts will only interfere with a decision that is otherwise lawful or procedurally fair if the decision is so perverse that it can only have been arrived at by the improper exercise of power.
With-profits	A policy that is issued with profit shares in the distribution of surplus from the relevant fund by way of bonuses.
Zillmerisation	An allowance for acquisition costs that are expected, under prudent assumptions, to be recoverable from future premiums. Named after the Prussian actuary, August Zillmer, who first adopted the method of calculating modified life insurance reserves.

**APPENDIX C****FEDERATED SUPERANNUATION SCHEME FOR UNIVERSITIES**

1. The modern history of the Equitable Life began with intimation of the impending demise of the Federated Superannuation Scheme for Universities (FSSU). Until the 1970s the Society was a small, relatively old-fashioned and generally conservative company. A substantial proportion of its business was derived from the scheme.

2. The background to the scheme was described to the Board on 14 March 1973. The FSSU was a money-purchase scheme funded by joint contributions of university employer and university employee, amounting to 15% of the employee's salary, to assurance policies with an office selected from a panel. Benefits bore no direct relation to final salary. University teachers had considerable flexibility in selecting benefits. If a qualifying member of staff wanted to maximise life cover he or she was able to select endowment assurances. If the individual wanted to maximise retirement benefits, he or she was able to select deferred annuities. The policies were transferable on change of position and university. In the post-war years a fundamental drawback of the retirement benefits scheme became apparent with salary inflation: the proceeds of the policies effected from a fixed percentage of salary over the years provided inadequate benefits at retirement. The State began supplementing pension provision where benefits were below one seventy-fifth of final salary for each year of service. The scheme was given some of the characteristics of a final salary scheme by means of public subvention. The university teachers retained the flexibility of the original scheme with the extra safeguards that afforded.

3. The business was valuable to the Society. In his statement to members in the Statutory Accounts for the year ended 31 December 1966 the president informed members that:

“Our associated office, the University Life Assurance Society, provides a useful service to the class of member for whom it was designed. The holding has been carried in our balance sheet for many years at what is a purely nominal figure. It seemed appropriate that the holding should be put on a value more in keeping with the income receivable by the parent society and the amount of the writing-up has been carried to the inner investment reserve.”

The asset was written up from £29,900 to £1m. Universities business was an important source of revenue. It supported the Society's staff and other resources required to carry on business.

4. The Finance Acts 1970 and 1971 introduced a new uniform code for pensions schemes and prevented the FSSU from continuing in its then current form. Negotiations succeeded in achieving a transitional period to 1980 being allowed for adjustment to the new code. A modified scheme was negotiated and given outline approval by the Inland Revenue by March 1973.

5. In his 1970 statement, the president, Ford Geddes, commented on the effect of the provisions of Finance Act 1970 on occupational pension schemes:

“They especially affect the FSSU, the pension scheme for University teachers. With our full support, our many friends in the university world have been seeking exemption from those provisions of the Act which prevent the continuation of the scheme in its present form. The Chancellor has announced a postponement till 1980 which, while falling short of exemption, does preserve much of the existing arrangements and gives time for us, and the other life offices involved in the FSSU, to adjust the future arrangements to the best advantage of our University members.”

6. Branch expansion had already begun in anticipation of the changes, and is described later. It continued. In 1971, the president reported:

“The Society is the leading life office in the FSSU ... which has contributed to the expansion of the Society’s business. ... The adjustment of the FSSU to the new pension code by 1980 has occupied much time this year and we have been keeping in close consultation with those responsible in the university world.”

7. In 1973, the report stated:

“Since the legislation in Finance Acts 1970 and 1971 has forced amendments upon FSSU, to become effective in 1980, the universities have felt it timely to consider the possible introduction of a self-administered scheme linking pension directly to salary at retirement, and it is expected that the new scheme will be introduced in 1975. The proposed scheme will be compulsory for teachers appointed after April 1975 and it is intended that existing teachers should have the opportunity to transfer to it at any time up to 1980, if they wish to do so.”

8. The new scheme was to take the form of self-administered terminal salary scheme. Members transferring to the new scheme lost the benefits of personalised money purchase policies in exchange for benefits wholly related by formula to final pay and years of service. The Universities’ Joint Consultative Committee under the chairmanship of Sir Douglas Logan recommended to universities that they should adopt the terminal salary scheme for all new university teachers after April 1975, and that existing FSSU members should be given an option to transfer to the terminal salary scheme, giving up all their rights under FSSU including cash for service to 1980 and protected death benefits, and making over their FSSU policies to the trustees of the new scheme to go some way towards meeting the back-service provision for teachers in the new scheme.

9. Government supplementation was to be withdrawn for future members of FSSU after a date to be fixed. Without that floor it seemed clear to the writer that in an inflationary world no future new entrant could choose FSSU policies. Existing teachers would continue to enjoy the right to supplementation at the current level, but that would mean an effective reduction in support to the member because of differences in the taxation of benefits. When supplementation ended any incentive to remain in the scheme would disappear.

10. The president said that the implications for the Society were uncertain, but to be likely to be that:

1. There would be a terminal salary scheme in existence probably from 1975;
2. There would be no new entrants to FSSU after 1975;
3. There would be few existing members transferring into the terminal salary scheme until the latest possible date which was expected to be April 1980;
4. In 1980 there would be substantial transfers of members especially of the younger members aged under 45, since for those members the FSSU policies would be transferred to the terminal salary scheme trustees, and the future of the policies would depend on the trustees’ views of the policies as investments; and
5. For existing members who opted to stay in FSSU incremental policies would be required for about twenty years.

11. In the 1974 accounts, the president reported the universities’ decision, and intimated that the Society would continue its association by assisting to ensure a smooth transition to the new arrangements. He continued:

“It will be apparent that, following the decision of the Universities to set up a new pension scheme, there will be a change in the composition of our business during the next few years as business associated with FSSU is replaced

gradually by expansion of sales of life assurance and pension policies to individuals and of group life and pension schemes. Previous statements have reported our expansion policy designed to secure a strong future for the Society.”

12. A policy of expansion had been initiated before publication of the threat that the FSSU scheme would be undermined by Finance Act 1970. But the loss of the FSSU business was a serious blow to the Society and prompted a drive for new business at what was to prove a critical time. This is discussed in chapter 3.

13. The drive for new business imposed considerable strain on the Society in financial terms and generally. An unusual and inexplicable manifestation of the general strain came to be reflected in a view that FSSU was in an ill-defined way at ‘fault’ for driving the Society out into the market place to search for new business opportunities. In a report dated 28 November 1979 it was observed that since FSSU had precipitated the Society’s need for growth in single premium business, it seemed proper to share the cost of that new business between the universities scheme and the with-profits fund. There was a similar comment in a report dated 25 February 1981. The view may reflect a degree of disappointment at the course events dictated by the changed tax regime. But on any view it does reflect the serious adverse impact on the Society of the loss of the business.

14. The Board of Equitable had repeated discussions on the FSSU position in the course of 1974. Among other references, one demonstrated the impact of the change on the Society’s wider role in the industry. On 23 October 1974 it was minuted that:

“In view of the potential problems arising from the FSSU situation it was decided that the Society should not participate in the consortium being formed to assist (London Indemnity and General insurance Co, Ltd.)”

The implications of the loss of FSSU business became a major influence on the Board’s thinking throughout that difficult year. But there was an anxiety to maintain levels of distribution in the difficult financial circumstances of 1973 and 1974, and 1976.

15. In the event, loss of FSSU business became a central factor driving a policy of business expansion between 1973 and 1980. The need to maintain and to project the attractiveness of the Society’s policies and bonus practices in support of business expansion in other fields had a significant influence on management throughout that period.



**APPENDIX D****TEXT OF TREASURY LETTER TO MANAGING DIRECTORS, 18 DECEMBER 1998**

Dear Managing Director

**GUARANTEED ANNUITY OPTION COSTS AND POLICYHOLDERS' REASONABLE EXPECTATIONS**

As you will know the Government Actuary's Department undertook a survey of life offices' exposure to guaranteed annuity options (GAOs) earlier this year. The results of that survey indicated that the exposure to GAOs was relatively widespread within the industry and had the potential to have a significant financial impact on a number of companies. The nature of the guarantees offered by companies varied widely, but one issue that needed to be addressed by all companies was how the concept of policyholders' reasonable expectations (PRE) should be interpreted in the context of GAOs. The purpose of this letter is to provide some guidance to companies on the Treasury's interpretation of PRE in these circumstances.

As a starting point, we take the view that policyholders entitled to some form of annuity guarantee or option on guaranteed annuity terms could reasonably be expected to pay some premium, or charge, towards the cost of their option or guarantee.

Charging for the cost of providing a guarantee or annuity option

For linked contracts, any charge would have to be included within the normal explicit charges levied under the terms of the contract, and these charges could clearly only be raised to cover the costs of guarantees to the extent that this was permitted under the contract. Any cost arising to the office in respect of meeting the guarantees over and above the accumulated charges, would therefore have to be covered by the insurer from other available resources.

In the case of participating policies, any charge could be deemed to be met out of each premium received (or the investment return to be credited by way of bonus), and hence would impact on the assessment of bonuses, including in particular any terminal bonus that would normally be payable to the policyholders. Generally we consider that it would be appropriate for the level of the charge deemed to be payable by participating policyholders for their guarantee (or annuity option) to reflect the perceived value of that guarantee (or option) over the duration of the contract. This could be achieved in some cases through some reduction in the terminal bonus that would be payable if there were no such guarantee (or option) attached to the policy. However the selected treatment by each office would need to depend on the wording of the contract involved and how it had been presented to policyholders.

Under the majority of participating policies which have been written it appears that any guarantee or annuity option is applicable to at least the guaranteed initial benefit under the policy and any attaching declared bonuses. As a consequence of this, we would expect that for most companies the present guaranteed cash benefits (including declared bonuses) would be converted, as a contractual minimum, to the annuity on the guaranteed terms. However as indicated above, it would appear possible, depending on the particular circumstances relating to the contract, that any terminal bonus added at maturity may be somewhat lower than for contracts without such options or guarantees, and that this terminal bonus could in some cases be applied at current annuity rates.

Apportionment of costs of GAOs not recovered under-the relevant contract

In the case of both participating and non-participating contracts any residual cost for the insurer in respect of annuity options and guarantees will need to be recovered from available resources within the long term fund or from shareholder funds.

Where the long-term fund is to be used, we would in the first instance expect to see the cost met out of any 'estate' held by the company. However, where the cost is significant relative to the estate available, then an insurer may wish to consider adjusting the future bonus allocations for some or all of its participating policyholders, or making a transfer to the long term fund from the shareholders' fund.

The appropriateness of any such adjustments to bonus allocations for participating policyholders would need to be assessed by each office in the context of the reasonable expectations of all their policyholders. This assessment will be influenced by their policy documents and any representation made through marketing literature, bonus statements or elsewhere.

The above is the Treasury's considered view, and is without prejudice to any decision of the courts which may affect it.

Please supply a copy of this letter to your Appointed Actuary,

Yours sincerely

Martin Roberts  
Director, Insurance

**APPENDIX E****FSA'S PROPOSALS FOR REGULATORY CHANGE****Introduction**

1. Reform of the regulatory system has been an ongoing process while I have been undertaking this inquiry. Shortly after my appointment, the report of a committee chaired by Ronnie Baird into the regulation of Equitable between 1 January 1999 and 8 December 2000 was published and submitted as evidence to the inquiry<sup>1</sup>. This report contained a detailed analysis of evidence, both documentary and oral, relating to the activities of prudential and conduct of business regulators and of GAD over that limited period. The inquiry has not sought to provide an analysis in similar detail for that period. In general the Inquiry has found no reason to dispute the purely factual material narrated by Baird, and where there have been differences of fact or inference I have set out my own views. In chapter 7 of the report, Baird summarised the committee's conclusions and made recommendations for change.

2. Earlier, in June 2001, FSA had set out in its consultation paper 97 proposals for an integrated 'prudential sourcebook' to replace the interim rule books adopted by the new single regulator in anticipation of the new regime under the Financial Services & Markets Act 2000. While the inquiry has been continuing, FSA has continued to bring forward detailed proposals for new rules and guidance to apply under the new regulatory system, taking forward and going beyond the proposals set out in the Baird Report, subject to a full consultation process that has allowed for professional and industry views to be explored and assessed in the development and refinement of proposals put to the insurance sector in a series of consultation papers, discussion documents and policy statements.

3. The output from this exercise to date has reflected a major, comprehensive re-assessment of the requirements of an efficient regulatory system for the insurance sector. The process has not been completed. And it is unlikely that there will be finality. FSA's powers to make rules and to provide guidance as set out in the 2000 Act will not be exhausted by publication of the integrated prudential source book and any associated guidance. Adaptation to the changing requirements of effective regulation will be necessary and will ensure that further changes will be proposed, explored and implemented or not as the process continues. Chapter 5 of consultation paper 202, of September 2003, already anticipates further change. Not least among these indications of future change is the need to align reporting requirements to emerging international accounting standards and the 'Solvency II' stage in the development of European regulatory requirements.

**Foundations of Regulatory Reform**

4. The foundations for the future operation of the new regulatory system were set out in FSA consultation paper 97, along with the first draft of the integrated prudential sourcebook, which is to come into effect from January 2004. This paper began by setting out the requirements for each of the main risks that could lead to a major financial loss or insolvency of an institution. The risks identified were credit risk, market risk, operational risk, insurance risk, liquidity risk and group risk (where applicable). How individual requirements would be set on firms was not yet covered. The paper noted that the aim of the prudential source book was to highlight and facilitate a clear understanding of what was and was not achievable through regulation, and that the risk of insolvency was an occurrence that would be

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<sup>1</sup> 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, submitted as evidence to the Inquiry conducted by Lord Penrose. Ordered to be printed by Parliament, 16 October 2001.

impossible to prevent. In fact, it was noted that this was a requirement which would have been an onerous, intrusive and costly to firms and to the regulators.

5. It will be appropriate to trace the development of some of the proposals. But note should be taken at the outset of FSA's policy stance on regulation generally. This was summed up in the FSA's September 2003 paper 'Regulation in a non zero failure world'; which set out the thought behind the FSA's non-zero failure regime and the implications for its regulatory activities. This was not a statement of new policy but a considered position that has been reached in the process to date.

6. FSA accepted that it was unachievable and undesirable to prevent the insolvency of all firms. They noted that they were committed to correcting many forms of market failure but that the failure of an individual firm did not indicate market or regulatory failure. The stated position was to set financial resources requirements in proportion to, not just the risk of failure of a firm, but the impact that a failure would have on its customers and on market confidence in general. With their risk-based approach to regulation, FSA have stated that they have decided to target resources to areas that offer the greatest risk to their objectives. To achieve this, they have said that they have developed a framework for allocating resources against risks, according to probability of failure and impact on consumers.

7. FSA have also stated that there are no guarantees that any regulated firm will not fail or that there will be no lapses in conduct of business regulation. They hope that by encouraging an awareness of the prudential regime amongst potential consumers, this will promote prudent behaviour by consumers and thus enable FSA to meet its core objectives; maintaining market confidence, promoting public awareness, protection of consumers and reducing financial crime, all of which are set out in the Financial Services And Markets Act 2000. This act also states that consumer protection means securing the appropriate degree of protection for consumers rather than removing all the risks. It is also noted that there will be circumstances, consistent with FSA principles, where failure or conduct lapse do occur but would not represent regulatory failure.

8. This September paper also the then chief secretary to the Treasury in 1999:

"Protecting consumers does not mean absolving people of responsibility for their investment decisions. It is of course the job of the regulatory system to ensure that consumers have sufficient information to make an informed choice. Consumers have a right to that but it is not the job of regulation to provide a guarantee that nothing can ever go wrong."

The idea of a non-zero failure regime is not a new one. This philosophy has been in existence from the time of DTI regulation of the insurance industry. This is evidenced in the files relating to the 1973 Act, and was expressed in interview by one witness who was a senior supervisor at the DTI in 1992:

"Within regulation there was a question of balance. Too much intervention hindered the market but if we weren't tough enough, companies could take liberties. Conversely, if there were no companies failing then it would be perceived that we were taking too heavy handed an approach. We were not there to prevent companies from failing."

A similar philosophy has applied to regulation of other sectors of the financial services industry, for instance banking. The systemic risks inherent in appearing to insulate the public entirely from the consequences of investment decisions have long been recognised. FSA have characterised this by saying that regulation can restrict instances of mis-selling, that is where consumers are misled by providers, but that consumers need to take responsibility for instances of 'mis-buying', i.e. a loss due to price fluctuation or an error of judgement.

### **Financial statements**

9. Much of this report has been taken up with an analysis of the financial statements of the Society presented to members and policyholders, or to regulators, and a comparison of the picture that emerged from the published material with the realistic position of the Society recorded internally. It has been a major contention that the Society's published financial statements did not uncover the Society's realistic position. Various forms of financial engineering; a lack of published information about aggregate policy values, including accrued terminal bonus; and the failure to recognise the cost implications of meeting policyholders' reasonable expectations, based on current practice, that terminal bonus would continue to be paid, subject to emerging market conditions, lay at the centre of that issue.

10. In their published consultation papers, FSA set out for discussion proposals for a new prudential sourcebook and the prudential requirements that it was intended should apply to life insurers. Throughout the course of their consultation with the industry as a whole, these proposals have been amended and refined in the course of the consultation process. The most recent statement of their current position in this process being consultation paper 207<sup>2</sup>. Many of the proposals within have been aimed at simplifying and facilitating the understanding of annual returns, or enabling comparisons between providers of long-term business to be carried out on consistent bases. It was intended that annual returns complying with the proposals would:

- Improve the timeliness and quality of the information received;
- Improve transparency of the key risks to which the entity is exposed;
- Ensure greater consistency of reporting of key product risks;
- Allow easier comparison and benchmarking of firms; and
- Allow external users of returns to make more informed decisions about firms and the industry.

These are important proposals but presentation is ancillary to the more fundamental issue whether necessary information is properly reflected in the statements in the first place. It is FSA's proposals for ensuring that the information is relevant and adequate which are of primary concern for the purposes of this report.

### **The 'Twin Peaks'**

11. As set out in consultation paper 97, FSA's stated aims and proposals were intended to deal with and set requirements for risk, which could cause a firm to either suffer from major losses or become insolvent. The risk areas that had been identified were; credit risk, market risk, operational risk, insurance risk, liquidity risk and, in appropriate cases, group risk. It was noted that insurance firms would have two main obligations:

- To maintain adequate resources: offices would be required to measure their exposure against each of the risk categories listed (except operational risk) and hold capital resources against them; and
- To maintain adequate systems and controls for managing their risks.

12. It was said that recognition of these obligations in financial statements would lead to a number of significant changes affecting insurers. These would include:

- An increased emphasis on the identification and management of risks relative to the adequacy of technical provisions and the solvency margin.

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<sup>2</sup> Treating with profits policyholders fairly – December 2003

- A requirement that firms take a view of the overall level of financial resources required to enable them to meet their liabilities, and development of appropriate stress tests and scenario analysis to support their assessments.
- Extensive new guidance on systems and controls and simpler asset valuation rules more explicitly linked to the relevant market or credit risks.
- Clearer requirements on managing with-profits business, including codifying existing practice on attribution of estates. There would be an explicit requirement for terminal bonus provisions to be included in the balance sheet.
- Increased base capital requirements to reflect the changes to EU directives as a result of the 'Solvency I' review.
- New requirements relating to the outsourcing of key functions, reminding firms of the need for certain procedures to be exacted to address the risks that could arise where firms outsourced certain functions that were material to the risk profile.

13. In marked contrast to the position over the period studied, the current regulatory returns that formed the background to these, and later FSA proposals disclosed terminal bonus rates. But the information provided did not assist the reader to calculate policy proceeds. FSA proposed to remove the requirement to disclose terminal bonus rates in the valuation report and to substitute a new form showing maturity payouts and surrender values for specimen policies and the amount of terminal bonus and market value adjustment included in, or subtracted from, the payout. All reporting firms would be required to provide this information to give a comprehensive picture. The proposal was that the return would show policy payouts as at 1 January, to give firms sufficient time to compile the information before submitting the annual return. FSA recognised that many firms changed their terminal bonus rates in the early part of the year as a result of the annual valuation investigations. FSA stated that they would continue to ask firms for their payouts at other dates in the year.

14. In November 2001, FSA published a paper covering the action that it had already undertaken or planned to take to implement the recommendations set out in the Baird Report. Among other criticisms of prudential regulation the Baird report had concluded that it did not take account of the nature, diversity and scale of risks in insurance firms. FSA proposed to strengthen the prudential regime by improving the basis on which solvency requirements were determined by placing more explicit responsibility on firms' management to maintain proper systems and controls, and by improving public and regulatory reporting. It was envisaged that this would address several of report's recommendations, including provisions for guarantees and options, financial reinsurance, the responsibilities of the appointed actuary and the regulatory returns as well as solvency.

15. The Baird report had said that prudential regulation had been too reactive and been overly reliant on desk-based returns. FSA responded to this by stating that they proposed to institute a more proactive risk-based approach to regulating insurance. More responsibility would be placed upon the management to maintain adequate standards and come into line with other areas of financial services (in areas such as corporate governance, risk management and systems control). All firms would be expected to comply with their obligations under FSA principles, and to deal with the regulators in a more open and co-operative way.

16. FSA initially addressed the area of enhanced capital requirement in consultation paper 143, dated July 2002, which dealt with feedback from consultation paper 97. This paper identified the risk that an office using the net premium method of valuation might fail to retain enough reserves to maintain policyholders reasonable expectations that bonuses would increase if markets

improved. They put forward an approach to avoid the potential problem of ‘margins on margins’, proposing that an office hold the higher of:

- Their current calculation of mathematical reserves plus the EU directive capital requirement; and
- A realistic value of the sum of (a) expected future contractual liabilities; and (b) projected fair discretionary bonus payments.

If the sum of the realistic elements was greater than the mathematical reserves and the EU directive capital requirement, the office would be required to hold ‘top up’ capital, designated the ‘with profits insurance capital component’. This became the FSA’s ‘twin peaks’ approach. It is intended that this approach will operate in a similar fashion to the approach used in banking supervision.

17. These proposals were developed further in consultation paper 195<sup>3</sup> dated August 2003. They included:

- Reserving and capital requirements for with profits business, ensuring that firms could adequately cover their expected contractual liabilities and discretionary payments (such as terminal bonuses).
- That firms tested the adequacy of their financial resources by carrying out appropriate stress and scenario tests, thus enabling FSA to tailor its individual capital guidance taking into account the firms business and control risks; and
- Other associated reporting requirements, particularly those that related to with profits business.

This paper revised the approach initially set out in consultation paper 143. The changes proposed were

- The removal of the requirement for mathematical reserves for conventional with profits business to be calculated using the net premium method. The requirement to adjust the assessment of future premiums would be removed.

Mathematical reserves would no longer be required to include an allowance for future discretionary bonuses. The draft rules and guidance would allow a firm to change from a net premium method of calculation to a gross premium basis, but only if the firm operated a twin peaks approach. The result of this change would be that mathematical reserves would only be expected to represent a reasonable assessment of contractual benefits. Future discretionary benefits would be separately assessed and explicitly reserved for under the realistic peak instead.

- The introduction of a requirement for a risk capital margin in the realistic peak ensuring that the with profits insurance capital component calculation had an allowance for adverse experience, risk capital margin being defined as the additional capital a firm would require to cover the effects of a prescribed market scenario. It would address major business risks such as market risk, credit risk and persistency risk a firm conducting with profits business would face.

18. It was proposed that the twin peaks approach would only apply to firms that had with profits liabilities greater than £500m, its use being discretionary for firms with liabilities below this figure. Smaller firms would be excluded from this requirement due to the higher comparative cost of introducing a realistic approach. However, these firms would continue to use the net premium valuation method. All firms would be required to hold the EU minimum requirement at least. The effects of these changes would be to reduce the required provisions when markets, and subsequent projected discretionary bonus payments, fell.

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<sup>3</sup> Enhanced capital requirements and individual capital assessments for life insurers – August 2003

19. Any firm that chose to undertake this approach would be required to assess the financial resources needed for with profits business as part of a 'Pillar one' requirement (admissible assets less foreseeable liabilities). Firms would need to consider the Insurance Companies Act and financial resources stress and scenario testing requirements separately. The FSA stated they were trying to introduce a degree of harmonisation between financial sectors.

20. FSA stated that it would accept the asset share approach and the bonus reserve approach as acceptable when a firm was calculating its realistic liabilities. They assumed that firms using the twin peak approach would have access to the gross premium, contractual method and other modifications to the mathematical reserves and thus be capable of a more robust assessment of their realistic position.

### **Factors relating to Equitable**

21. The report has identified the Society's use of a quasi zillmer adjustment its failure to reserve properly for annuity guarantees, and its application of financial reinsurance as failures to comply fully with the existing requirements. The FSA's discussion of zillmerisation reflects the position that had been obtained at all material times. Equitable's quasi zillmer adjustment was not adequately described or disclosed in the Society's returns. The requirement that all should comply with their obligations under the FSA's principles, and deal with the FSA in a more open and cooperative way should ensure that problems do not recur, provided that discipline is effective.

22. With regard to guarantees and options, FSA set out plans in consultation paper 195 to require all firms to reflect any guarantees and option obligations at market value, or to value them according to market based stochastic modelling techniques to ensure that they reflected the time value of these options and guarantees. If this approach was not possible, FSA stated that a firm could derive a valuation via deterministic projections, but this approach was identified as a less desirable option. It was further stated that a firm would be required to reserve against the possibility that an option, not of value to a policyholder at the present date, might become so in the future.

23. The Baird report recommended that the exercise of discretion over the use of future profits implicit items be reviewed. FSA responded that new guidance would strengthen the requirements of firms to show the existence of future profit and provide a more precise requirement for close monitoring by management. The FSA noted that the use of future profit implicit items would be restricted through changes to the EU directives, as part of the Solvency I review. This was discussed in consultation paper 181<sup>4</sup>, when it was noted that future profits implicit items would be phased out between 2007 and 2009. FSA further noted that they proposed to exclude future profits implicit items from the definition of capital over that time period also.

24. It was also proposed that waivers would not be granted under section 148 of the Financial Services Markets Act for future profits implicit items, to count towards a firm's minimum capital requirement, where the implicit item would increase regulatory surplus to more than the realistic surplus on the fund. That restraint was in addition to the limits derived from the life assurance directive<sup>5</sup> amended by Solvency I directly. By 2007, future profits implicit items would have to be restricted to 25% of the lesser of the long term insurance capital requirement and total eligible capital resources. By 31 December 2009, it was stated that they would no longer apply.

### **Reinsurance**

25. Financial reinsurance supported Equitable's regulatory solvency position at critical times. It was identified in the Baird Report as an area that required review

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<sup>4</sup> Implementation of the Solvency I directives – April 2003

<sup>5</sup> Council Directive 92/49/EEC

and the FSA response was that they intended to deal with this issue. The issue was addressed in consultation paper 144<sup>6</sup>, dated July 2002, which set out the approach that would be taken to firms' use of financial engineering. This paper noted that the use of financial engineering instruments was likely to be reduced if accounting standards for insurance moved towards a fair value basis and a more risk sensitive European prudential regime was introduced. The FSA expected that, in the medium to long term, weaknesses concerning financial engineering in the prudential regime would be likely to be resolved by adopting internationally recognised accounting standards for insurance and through new more risk sensitive EU capital and solvency requirements. The paper stated that a start in that direction had already been made in the Solvency I directives.

26. The paper discussed regulatory issues concerning financial engineering. In relation to financial reinsurance, three categories were identified. The first involved a genuine transfer of risk where the price was small relative to the regulatory credit gained because the regulatory charge for the risk was high compared with the market cost charged by a third party to take on the risk. The regulatory objective in that case was to ensure that there was a proper transfer of risk, that the credit taken was appropriate and that collateral risks were properly considered. The second category involved a transfer of risk, but for a price charged on the future resources of the firm, potentially to the detriment of consumers. In life business, the regulatory rules were then poorly aligned to accounting rules and the realistic position was not disclosed. The aim was to increase awareness of the firm's entire situation, including an assessment of its realistic financial position.

27. The third category was described as follows

“In some arrangements, there is no genuine transfer of risk but full credit is taken for the ‘protection’ purchased. Practical examples of this have arisen by virtue of side letters which negate the value of the main contract but which are not disclosed or allowed for in reported results. These arrangements are clearly the most unacceptable. Some may even have been deliberately misleading and there will typically have been non-observance of existing regulatory and other requirements. The ABI SORP, for example, requires ‘entire arrangements’ to be taken into account. In these circumstances what is needed are better tools and warning indicators to help supervisors and auditors to spot potential transactions warranting further scrutiny. Classic warning signals will be large credits for apparently low cost.”

The warning signals can be seen to have been the distinguishing feature of the second category also.

28. FSA recognised the validity of financial engineering as a means of strengthening a firm's solvency position. They have highlighted the strengthening of supervisory scrutiny of financial engineering arrangements partly through the administration and scrutiny of applications for waivers for implicit items, where scrutiny has been enhanced since the Financial Services Markets Act came into effect as an aspect of the risk-based approach to supervision. They further note that attention will be paid to whether firms' senior management has:

- Satisfied itself that any financial engineering that the firm uses has a legitimate commercial purpose and effect;
- Has reviewed the effect of any financial engineering on the firm's financial position, both current and future within the context of its overall risk management strategy;
- Sets up and maintains proper systems and controls to monitor, manage and record such arrangements; and

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<sup>6</sup> A new approach to firms' use of financial engineering – July 2002

- Has ensured these arrangements are reported in the relevant parts of the regulatory return as required.

29. FSA noted that supervisors would be given enhanced training and guidance on how to identify and diminish risks in this area. Any issues identified would then be discussed with the firm's risk management and internal audit functions. They stated that more use would be made of specialist expertise and 'grey panthers', and skilled persons reports would be commissioned when necessary. Firms would also be required to provide any additional disclosures in the regulatory returns they considered necessary to aid users' understanding of the type of arrangements involved or entered into and their effect, consistent with their obligation to treat customers fairly.

30. These proposals dealt with the problems that arose from Equitable's financial reinsurance arrangements, whether assessed in the light of the documents originally disclosed or those documents supplemented by the side letter, whatever its effect. The FSA's proposals, recognising that there are no absolutes in this area, provide for appropriate levels of testing and assessment of the credit claimed for financial engineering.

31. In 1990 and 1994 Equitable released surplus by changing the approach to its valuation interest rate in the regulatory returns. In consultation paper 202, FSA has proposed a revised Form 57 setting out an analysis of the valuation interest rate used for each product, to demonstrate compliance with Rule 5.11 (the determination of liabilities).

32. The overall approach involves simplification of the amount and of the presentation of data. In existing returns the relevant data is spread between different paragraphs forms and notes. The new forms are intended to enable users to identify changes in the valuation bases, and will present, in tabular form, the relevant rates for the current and previous years. Provision will be made for the publication of mortality or morbidity assumptions either in tabular form or by narrative and examples. Expenses data for the main classes of business will have to be disclosed.

33. These proposals would not prevent a change of valuation basis such as occurred in 1990 and 1994. But they would ensure that the relevant data was presented clearly for the benefit of regulators and other readers.

#### **Prudential regulation generally**

34. It is FSA's position that the reform process will not be complete on implementation of the current proposals. Bearing in mind the competitive position of the UK in the provision of financial services, FSA have chosen not to anticipate the introduction of new international standards in areas such as operational risk to the extent that these would impose additional costs on firms, or to harmonise existing requirements by levelling up to the highest international standard on all firms regardless of sector, largely because of adverse effects on the international competitive position of the UK. There has been recognition that future International Accounting Standards may impact the balance sheet aspects of annual returns. FSA trust that their proposals will work alongside these changes and that is the reasoning behind why FSA currently propose limited changes to the publicly available annual return. International Accounting Standard changes will be expected to focus on the valuation method of assets and liabilities, which are not reviewed by FSA. They have noted that implementation of the new International Accounting Standard for insurance contracts will not come into effect before 2007.

35. The approach of the integrated prudential sourcebook will be based on an assessment of the impact of prudential failure rather than on the assessment of risk of prudential failure more generally. FSA has indicated that standards will be set that seek to measure and reflect the risks firms run and set the level of appropriate capital resources required, rather than increasing the level of capital resources to be maintained on more general criteria. Within the twin peaks approach, the insurance

solvency margin requirements have been set in accordance with EU minimum standards, which FSA feel might deliver low capital resources requirements relative to the risks posed by some firms. Where this is the case, firms will be required to make and justify their own estimates of required resources to result in higher levels of required regulatory capital

36. FSA accept that it is impossible and undesirable to seek to prevent insolvency of all firms. Their aim is to set financial resources requirements proportionate not just to the risk of failure of the individual firm and also to the impact of failure on consumers and on market confidence, but to aim short of requiring insurance firms to hold any amount of financial resources to protect consumers against any risk of loss.

#### **Individual Capital Adequacy Standards**

37. FSA has stated it proposes to introduce individual capital adequacy standards to meet its aims of:

- Ensuring that firms hold capital appropriate to their business and control risks;
- Emphasising the responsibility of senior management to ensure that a firm holds adequate financial resources;
- Providing incentives for better risk management; and
- Enhancing consumer protection and market confidence through a reduced but not eliminated risk of financial failure.

From January 2005, they expected life insurers to be able to maintain overall financial resources of quality and amount to ensure that there was no significant risk that they would be unable to meet their liabilities when they were due. To do this, firms would have to have had in place adequate systems and procedures to assess that they had sufficient resources to facilitate this, that they were able to identify any major sources of risk to ascertain the appropriate level of resources needed and to conduct appropriate stress and scenario tests on any major risks that they identified.

38. Firms will be required to self-assess their capital requirements, this process being known as an individual capital assessment. They will not be required to report these exercises regularly to FSA but will need to keep all records of their assessments, in line with prudential rules. The enhanced capital requirement or minimum capital requirement, if applicable, will be taken into account prior to giving individual capital guidance. The more that firms are able to demonstrate that their risk assessment processes capture and quantify all of the issues in FSA's guidance, then the lower the level at which FSA will be able to assess their individual capital guidance (and vice versa). A firm's individual capital adequacy will remain private between the regulator and the firm. Individual capital guidance given to a firm will not be published. The individual capital adequacy framework was planned for implementation in the latter half of 2004.

39. FSA have noted that they expect individual capital guidance to be targeted particularly at firms with:

- Poor controls and or weak management where capital may be a temporary solution;
- Exposure to areas with greater underwriting uncertainty such as longevity or morbidity risks;
- Material amounts of with profits business with embedded optionality and guarantees in the underlying contracts; and
- Rapid growth.

40. If the proposals in hand for the future operation of the new regulatory system are implemented, and if they are made effective in practice, in and after 2004, the major criticisms of the earlier regulatory system will have been addressed, both in relation to the general approach to regulation and in relation to the particular issues arising from the discussion of regulation of the Society. It is appropriate to offer encouragement to FSA to institute and maintain an appropriate system of prudential regulation, within the scope of the aims already set; to ensure that it is made effective by the application of appropriate resources; and to ensure that it remains relevant to changing industry needs.

#### **Conduct of Business regulation**

41. The criticisms of conduct of business regulation as it applied to Equitable have focused on two main issues: the lack of co-ordination between conduct of business and prudential regulation; and the lack of effective scrutiny of product management after point of sale. In the case of the Society's typical recurrent single premium contract the second issue was particularly relevant to the failure to consider the provisions that dictated an annual review of the relationship, in view of the lack of obligation to pay further contributions until agreement was reached and reflected in endorsement of the contract.

42. The Baird report made a number of recommendations in this area. It commented that, as the committee found the facts, the Equitable case had revealed uncertainty about the interpretation of the conduct of business rules and the standards of disclosure that should be expected of firms where customers were potentially exposed to significant operational risks, and recommended:

“We recommend that the FSA considers what standards of disclosure should apply [when customers are potentially exposed to significant operational risks] and the extent to which these can be codified.”

43. In the paper of November 2001 already referred to, FSA stated that this point was covered in the proposals for the integrated prudential sourcebook as per consultation paper 97, and that the recommendation would be covered in detail as part of the With-Profits Review. It was intended to propose that key information should be presented in summary form. Views would also be sought on the disclosure of asset shares to allow a better assessment of a fund's ability to meet guaranteed and discretionary benefits, which would be of great use to informed users of such information (such as IFAs, rating agencies etc...) who advised on such matters. A discussion paper would be published in Spring 2002 to consider the format, frequency and public disclosure of reports.

44. The Baird report also noted that the role of the enforcement division deserved attention. The committee's impression was said to be that once an issue had been referred to enforcement, there was limited communication between the investigating team and the team responsible for monitoring the Society. The lack of effective interaction was said to have meant that the opportunity to use enforcement, as a source of information regarding Equitable's treatment of policyholders, was lost and the implications of the House of Lords' decision on the investigation were never fully considered by either the enforcement division or the personal investments authority insurance business division. It was recommended:

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

FSA commented that it was implementing changes to ensure that advice and information flowed freely in both directions between enforcement and the supervisors and that management ensured that this was the case

45. The Baird report further commented that in the context of long-term business, the prudential regulator had responsibilities relating to PRE and customers'

interests, which were created and shaped by communications with policyholders. This was said to represent a matter of potential concern shared with the conduct of business regulator who had responsibility for ensuring that relevant communications with customers complied with its rules. The Baird committee's view was that, in the context of the Society's case, this area of common interest was not effectively managed. It was recommended:

“...that as part of the integration these two regulatory divisions, the FSA takes steps to ensure that responsibilities in this area are comprehensive and properly coordinated and managed.”

46. The Baird report had welcomed FSA's decision to create one division, comprising prudential and conduct of business regulators and GAD, to deliver integrated supervision of the insurance industry. FSA referred to these comments in that context, in response to the recommendation. They noted that they had already made a number of changes to their internal structure to aid its delivery of an integrated approach to insurance regulation. They highlighted that, from 2001, the largest insurers had been supervised by the major financial groups division rather than by the insurance firms division. This had allowed a common approach in regulation of large financial service groups. Communication between these two divisions was said to be essential to allow a common and coordinated approach to significant events (including identification of new sector wide risks). FSA further noted that managers in both of these divisions were already responsible for prudential and conduct of business regulation.

47. Policy relating to insurance industry firms had been consolidated in the prudential and conduct of business handbooks to facilitate a consistent approach to regulation and policy formation. FSA commented that supervisors also had more time to concentrate on supervisory issues as the authorisation division dealt with much of the work involved in authorisation of firms and routine notifications submitted by firms to the regulator. It was also pointed out that staff from GAD had been transferred to the Insurance Firms division in April 2001. Location in the same premises would achieve the aim of providing greater knowledge sharing, access to suitable technical expertise and speedier identification of potential industry concerns. It also enabled the all the relevant bodies to be more closely involved in regulatory process and policy work.

48. In summary, FSA's position in their November 2001 report was that the changes already implemented were:

- FSA now had responsibility for consumer products pre and post sale. Previously, responsibility towards consumers and products had only been recognised up to and including the point of sale;
- Their unified conduct of business sourcebook had come into force;
- The focus on senior managements responsibility for systems and controls had placed a greater obligation on the management to ensure that their firms met the standards laid down for service provision to customers;
- Conduct of business issues had been embedded into the supervisors assessment of a firms risk profile and their selection of regulatory tools applicable;
- The new framework to capture and assess risks and opportunities which face consumers and/or run across industry sectors, of which the risks associated with poor standards of advice were the most obvious;
- Formation of a new division to support work carried out by the FSA to meet their consumer led objectives (i.e. improving the financial literacy of the public).

49. The integration of enforcement functions with regulatory functions raised issues of some complexity that the Baird report did not reflect. The collection of

information for regulatory purposes and the assembly of evidence for enforcement have usually been regarded as requiring different approaches best reflected in maintaining the independence of the enforcer, who could then concentrate on ensuring the integrity of the materials with a view to meeting challenges in subsequent proceedings. To date, FSA's publications have avoided this issue.

50. In January 2003, consultation paper 167 published proposals that arose from papers published as part of the With-Profits Review, and spanned the areas of prudential and conduct of business regulation. The initial proposals in this consultation paper discussed the idea of principles and practices of financial management documents. It was proposed that with-profits firms would be required to:

- Define and make publicly available the Principles and Practices of Financial Management (PPFM) applied in their management of with profits funds;
- Ensure that their governance arrangements offered assurance that they had managed their funds in accordance with the PPFM that they had established and published; and
- Produce annual reports for with profits policyholders on how they had complied with this obligation, including how they had addressed any competing or conflicting rights, interests or policyholders expectations and, if applicable, shareholders.

51. The feedback on this consultation paper was published in Policy paper 167, dated June 2003. The FSA had decided that firms had to define and make available their PPFMs by the end of March 2004. Consistency would be required between the assumptions underlying any projections on which realistic reserves were based and the PPFM disclosed to with profits policyholders. These would have to be reported and disclosed publicly. A number of general and specific issues were clarified, and criteria for acceptable definitions and statements of PPFMs were set out

- Statements lacking the detail necessary to enable a knowledgeable observer to understand the risks and rewards in maintaining a with profits policy could be a breach of the FSA's conduct of business requirements;
- Representations made to policyholders during the sales process were to be reflected in the PPFM. This public document should not lead to a change in policyholders expectations;
- The PPFM would be less burdensome and detailed where a firm was less complex or had small with profits liabilities;
- That they would be made available upon request, not as a matter of course;
- Any change in practice by the firm was to be given three months before the effective date before any change could be made in a published principle;
- A firm with more than one PPFM had only to give notice to those policyholders affected;
- Policyholders were entitled to know what a firm's approach to a closure to new business might be and what changes would occur. Any foreseeable risk that would have an impact on the firm's management of it with profits fund had to be covered by the firm;
- Any inherited estate issues and their treatment post closure were to be well defined;

- The PPFM was tied in with realistic reporting for with profits funds as the calculation of realistic liabilities had to be consistent with a firm's actual practice in setting bonus levels and how this was represented to policyholders.

FSA decided that it would not publish a model code of practice for the PPFM. The onus for the PPFM was placed directly on the board of the firm.

52. FSA's most recent consultation paper<sup>7</sup> published shortly before the finalisation of this report has commented further on the development of the PPFM in the context of treating with-profits policyholders fairly. They have found that there are still some areas in with-profits products that could prove to be potentially unfair to consumers and so feel that to counter this, better protection would be offered by new rules and guidance. FSA states that this will cover:

- The determination of amount payable under with-policies, including requiring firms to manage their business;
- An approach to surrender values that should better balance the interests of departing and remaining policyholders;
- Charges to with-profits funds; and
- The basis on which new business must be written.

FSA specified the requirement that firms which stop writing new with-profits business and go into run-off would have to provide adequate information to their policyholders, to make them aware of the options available to them in such a situation. Due to this and the above points, there had been a recognition that firms will need to make changes to their PPFMs to take these new rules into account. With this in mind, it has been indicated that these changes will not become effective until March 31 2005. It has been further decided that companies should present information in their PPFMs to policyholders in an easily understood format, which will subsequently allow firms to dispense with the requirement to produce with-profits guides. It is hoped that the PPFM will address the questions of, and make more transparent, how firms invest their with-profits funds and decide the level of payouts to policyholders. The production of a clear, concise and easily understood PPFM for consumers, derived from a more detailed document is potentially the most important statement to be included in this paper. This proposal should require companies to provide detailed information, in an easily understood format for consumers, on how the fund is managed, the investment mix and liabilities associated with the with profits fund. The key aim, restated again, is to improve transparency.

53. FSA have stated that, to address concern on amounts payable under with-profits policies, they also intend to put forward rules and guidance, for inclusion in the conduct of business handbook, These will aim to address: target ranges for payouts and smoothing, to enable outside parties to distinguish between firms on this basis; the definition of asset share for these purposes; the distribution of surplus, to minimise the risk that firms might underpay or overpay policyholders over time, and surrender values (including the right to apply market value reductions). This latter point should address the question of balance between current and surrendering policyholders. FSA's aim is that surrender values would be derived from premiums received under these policies.

54. FSA have also commented upon proposals they have in mind to improve the reattribution of inherited estates, where applicable, with the aim of ensuring that policyholders receive fair treatment through adequate representation of their interests. By reattribution, they mean that a firm may buy out the rights its policyholders have over the inherited estate, with policyholders giving up the value of what they might receive from a distribution of the estate. The idea of a

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<sup>7</sup> Consultation paper 207 – Treating with-profits policyholders fairly – December 2003

policyholder advocate has been put forward, to act in the interests of the policyholders if such a situation were to occur. The firm in question would appoint to this position, but with safeguards in place to ensure that the holder of this position would act in the interests of the policyholder independently of the firm.

55. The charging of costs to a with-profits fund, not directly linked to the fund's operation, is another area that the FSA have indicated they are looking at. They have stated that consultation is ongoing regarding rules to limit charges applied to a fund, to those directly concerning the fund. It has been noted that a key objective of the regulator, and thus requisite for new rules and guidance is to ensure that payouts to policyholders will not be reduced due to costs that may arise from a failure to meet regulatory obligations. FSA have proposed that deduction of any costs from individual's asset share will be an action of last resort.

56. FSA have also indicated their intention to conduct a programme of consumer testing, to ascertain whether information presented in PPFMs, initially proposed in policy statement 167, delivers the greater understanding of with-profits products to consumers that they hope to achieve, prior to it becoming effective in November 2004. It is hoped that this document will contain information enabling policyholders to understand how the firm manages their with-profits business and the effect upon amounts payable under such policies, that it is clearly written and kept up to date. Their ultimate aim is that a reasonable consumer should be able to understand it.

57. Consultation paper 170, dated February 2003, discussed the measures that FSA planned to take to improve the effectiveness of product disclosure of pensions and investment products. The core feature of this would be the key features document (KFD) (the key features document was to replace the key facts document of the previous regulatory regime), which would be made available to a consumer as early into any sales process prior to purchase of any product, thus complying with EU directive requirements. The information detailed in this document would vary with the product sold, i.e. the KFD for a life product would contain an illustration reflecting a consumer's individual circumstance. FSA set out parameters for format, style and content of the new document.

58. Implementation of the proposals the FSA discussed would improve the quality of publicly available information about office practices and financial position as compared with Equitable's communications discussed in this report. In particular, the publication of PPFMs and of performance relative to published principles and practices would ensure that policyholders were informed of the relevant firm's smoothing policies and of the extent of deviation from a firm's published objectives. Over-payment on claims relative to the underlying assets backing with-profits liabilities and future bonus expectations would now be made explicit. But the proposals would be effective only if two conditions were met: effective corporate governance and effective supervision.

### **Corporate Governance**

59. FSA has subjected the governance of with-profits funds to critical review. The Baird report recommended that appointed actuaries be subject to independent external review at a level that would provide comfort equivalent to that provided by an external audit. The committee's view was that while the appointed actuary system had worked well for a long time, reliance on one individual with no external, detailed check of his work inevitably posed risks. The position of Equitable over many years when the Board was ill-equipped to challenge the actuary's advice and form an independent judgment on the actuarial management of the office, has been dealt with at length in this report.

60. FSA's initial response to the Baird report was to note that from 1 December 2001, the approved persons regime would address the issue. They recognised that it was not appropriate for an appointed actuary to hold the responsibilities of another senior role within a company. They stated their intention to address this area further, noting that they would have assistance from the actuarial profession. In

January 2003, consultation paper 167, dealing with governance, the role of actuaries generally, and certification of financial statements was published. The aim of this paper was to set out proposals to improve transparency; strengthen governance of insurance firms; and simplify certification of returns.

61. Proposals were put forward for the discontinuance of the existing appointed actuary regime, and the introduction of two new actuarial functions; a new general actuarial function applicable to all insurers, and a specific with-profits actuarial function, both of which would be controlled functions. It was stated that boards and senior management would take overall responsibility for the actuarial aspects of the business. It would be for the directors to satisfy themselves concerning the reserves a company held, and that liabilities were valued appropriately. Both areas would be brought within the scope of the audit. Directors would be required to take decisions on all key areas relating to the soundness of the firm, obtaining actuarial advice where appropriate. There would be a change to the regulatory regime to underline the responsibilities on firms' directors for the valuation of policyholder liabilities. The new with-profits actuarial function was intended to remove any tensions between policyholders and shareholder interests. The appointed actuary had personal responsibility under the current regime to advise on the use of discretion when establishing amounts payable to policyholders, and an equivalent was required. It was intended that regulatory responsibility would be focused on policyholder interests.

62. FSA stated that firms writing long term business would be required to set up an actuarial function to advise senior management on a range of issues, especially liability valuation. They specified that the holder of this office would be a member of Faculty or Institute of Actuaries, and an approved person under the Financial Services and Markets Act. The role of the with-profits actuary would be similar. Firms would decide where responsibilities lay, where there was potential for overlap between the two roles. Both actuarial functions would be subject to whistle-blowing requirements if HMT introduced regulations under section 340 of Financial Services and Markets Act. FSA supported the introduction of these regulations.

63. To help avoid conflicts between the two actuarial functions, FSA proposed that a possible solution would be:

- To make the with-profits actuary independent of the firm. This would enable independent advice but could lead to lower levels of involvement with the firm and a lesser understanding of the firms business; and
- Where the with-profits actuary or anyone performing both actuarial functions was a member of the firm, they would not be allowed to be a member of the board.

64. It was also proposed that directors and senior management be more responsible for setting up technical provisions and other decisions taken on actuarial advice. The requirements for certification of financial statements would change to reflect the new proposals. FSA identified as a weakness of the current regime, the restricted requirement of directors that they certified explicitly some aspects of the returns but not others. One aspect of the revision of the certification process was that it would include the actuarial investigation, presently certified by the appointed actuary. It was proposed that directors take explicit responsibility for all aspects of the regulatory returns.

65. The director's certificate would include a management report, similar to the director's report in the Companies Act accounts, and a directors' certificate. The management report would apply to life insurers only and would be a narrative report. The information required would be that already required in the actuary's abstract report in current practice. It was noted that there would be a reduction in the amount of information reported. The report would be divided into sections to allow users to see clearly the information that applied to specified areas. The aim was to make the directors' certificate more streamlined than the current certificate,

similar to the current actuarial certificate. This would be the same for life and non-life firms, excepting specific statements for special aspects of the life business.

66. The scope of the audit would extend to include the valuation of policyholder liabilities and other aspects of the regulatory return that were previously the responsibility of the appointed actuary, due to concern that without independent work, the appointed actuary did not benefit from the challenge of other actuaries and other professionals with relevant experience. FSA proposed to require auditors of life firms to obtain a report from an actuary on the valuation of policyholder liabilities as part of the audit work. An actuary independent of the firm and its actuarial function would provide this advice. Rewording of the audit contract would bring it into line with Companies Act requirements. That would ensure that the regulatory returns approach would come into line with the approach in the Companies Act accounts.

67. Feedback on consultation paper 167 led to some amendment of the proposals that had been previously put forward. With respect to the with-profit actuary's report to policyholders, FSA proposed that the scope of the with-profit actuary's duties would include producing a statement to accompany the annual report to policyholders, to state whether in his opinion, based on information supplied by the firm, the firm's report and the discretion exercised during the period under review could be regarded as having taken policyholders interests into account in a reasonable and proportionate manner. The proposal to annex the with-profits actuary's report to the firm's own report would come into effect when the new actuarial roles came into effect.

68. Regarding the future role of actuaries, changes in emphasis of the initial proposals were noted as a result of the feedback. FSA noted that:

- While they remained of the view that it should be permissible for an individual to perform the roles of the with-profits actuary and the actuarial function, firms should have the ability to have different people performing the two roles, recognising that the with-profits actuary's advice was focused on the fair treatment of policyholders and represented the expectations and interests of policyholders.
- The with-profits actuary, and any actuary performing both roles, should not be a member of the board but should have the right to attend board meetings. An actuarial function holder performing only this role could be a member of the board. The actuarial function holder's scope was widened to require the officer to monitor the financial condition of the firm and advise on capital needed to support the business.
- The with-profits actuary would report to the board, at least annually, on key aspects of the discretion exercised during the year, including any issues affecting the PPFM. The board would have a duty to keep the with-profits actuary informed of all relevant aspects of the business.
- The with-profits actuary would have to state whether, on the information supplied, the discretion the board exercised during the review period could be regarded as having taken policyholders' interests into account in a reasonable and proportionate manner.
- Where schemes of arrangement or other documents delegated certain duties to the appointed actuary, firms would need to put in place alternative arrangements. The with-profits actuary or the actuarial function might carry out these duties.
- The reviewing actuary should provide a published opinion on the valuation of policyholder liabilities.

69. FSA produced and published a document entitled the "With Profits Governance Instrument 2003". This detailed an amendment to the conduct of business sourcebook, namely the inclusion of rules that dealt with the application

and purpose of the Principles and Practices of Financial Management coming into force on 31 March 2004. The amendments to sourcebook included rules dealt in detail with the firm's requirement to pay due regard to the interests of its customers and treat them fairly. It also noted the provision that a firm's PPFM must cover their approach to smoothing the value of its with profit policies. It was noted that the firm's with-profits principles should:

- Indicate whether and in what respect a firm took a significantly different approach to smoothing depending on the type of claim arising from with profits policies;
- Indicate whether smoothing was to be neutral over time;
- Indicate whether there was any total scale or cost of smoothing to the firm over the shorter term that a firm believed should not be exceeded; and
- Indicate whether the firm applied market value adjusters or changed the surrender bases for with-profits policies that were not unitised only to reflect changes in the underlying asset values.

70. Proposals for reporting and audit for firms within the scope of the enhanced capital requirement were refined further, and there was further consultation on two new reporting forms to support the assessment of capital for with-profits business under the twin peaks approach. Two new forms would be introduced, forms 18 and 19 with subsequent amendments to the present form 9. An earlier consultation paper<sup>8</sup> proposed a form 9B to show the effects of financial engineering on the with-profits fund. However, this was postponed following further consultation until a more appropriate realistic presentation had been developed. FSA's draft rules and guidance addressed these concerns: form 19 would fulfil the intended aim of form 9B by providing a clear picture of the realistic solvency position of a with profits fund, including the effect of any financial engineering. Forms 18 and 19 would form part of a firm's annual reporting requirement and so would be publicly disclosed. It was also proposed that firms would disclose the assumptions underlying the calculation of their realistic liabilities and risk capital margin. Forms 18 and 19 would be submitted with a full valuation report annually, and at the firm's own financial year-end. Half-year reporting would be to the regulator only. FSA stated that these changes would be brought in and made effective in 2004.

71. In the case of Equitable:

- Delegation of liability valuation and management to the Actuary without adequate (or for most of the reference period any) supervision by the Board or its committees created a gap in governance that allowed the Actuary to pursue policies that the Board accepted uncritically.
- Those policies led to a situation in which the Society was unacceptably weak and could not sustain the shock of an emerging liability that ought to have been within its capacity to absorb as a going concern.
- The combination in one individual of the internal and appointed actuarial functions and the position of chief executive created a position of dependence at Board level that was fatal to the interests of sound management of the business.
- Except in relation to its listed debt, Equitable, as a mutual, was affected by Cadbury and other codes only to the extent that it adopted them voluntarily.
- Equitable was not subject to any degree of effective policyholder influence.

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<sup>8</sup> Consultation paper 144 - A new regulatory approach to insurance firms' use of financial engineering – August 2002

72. The FSA's proposals would deal with the first and third points. Some observations on the general scope of the proposals could be made. But if, in their present form or as further developed, they deal adequately with the problems inherent in the former regime; they will cover the governance deficiencies at board and management level that the inquiry has sought to identify in Equitable. Their proposals do not cover points four and five.

#### **Director's Certificate and Audit**

73. Consultation paper 202 of September 2003 re-opened consultation on changes to the director's certificate and audit. As set out in consultation paper 167, the proposed changes reflected the FSA's objective of making directors more explicitly responsible for setting up technical provisions and for other decisions taken on actuarial advice. New audit requirements for policyholder liabilities were proposed plus changes to the returns affecting all insurers.

74. The proposals for the directors' certificate and audit have been expanded from the proposals first put forward in consultation paper 167. After feedback on the certification of returns, the FSA proposed that the directors' certificate should include confirmation that directors had taken actuarial advice from the actuarial function holder on the valuation of policyholder liabilities and that they had paid due regard to it. FSA proposed the requirement that the reviewing actuary produce an opinion whether, and for the directors' to certify that, they had received actuarial advice and paid due regard to it. FSA further proposed that the audit opinion be amended to remove reporting on the directors' certificate from the scope of the opinion, thus incurring no additional audit costs in respect of the directors' certificate. In this paper, FSA noted that a re-worded report would provide assurance on all financial data on the full balance sheet and solvency calculation within the annual return, and give an opinion on whether the statements in the directors' certificate and valuation report were consistent with the audited financial data in the regulatory return.

75. One of the aims of the FSA's new approach is to try to align the information of the Companies Act accounts and the annual regulatory returns, in that the financial forms would be consistent with the accounts and the valuation report within the director's report. This would enable reconciliation between the two in terms of increasing the transparency of the figures presented. They also stated in this paper, their intention to widen the scope of the audit review to cover areas of the annual regulatory return that previously came under the scope and responsibility of the appointed actuary, enabling independent scrutiny. Another proposal they have made is the requirement that auditors of life firms obtain a report from an independent actuary (i.e. not an employee or consultant directly retained by the firm), as a standard element of the audit, on the valuation of the firm's policyholder liability. The actuary advising the auditor would then review this. Upon completion of this review, the reviewing actuary would then be required to issue a personal opinion on the validity of the assumptions used and that the reserves have been calculated in line with these assumptions, that reserves meet the firm's regulatory requirement and that the firm's solvency margin has been similarly calculated. This personal opinion would then be produce in parallel with the audit report.

76. They further note that any future reporting requirements will be based around any future international accounting standards and Solvency II directive proposals, when they come into effect. They have stated that they expect this directive to introduce more risk based capital requirements and a greater regulatory emphasis on, amongst other areas, risk management and internal control and that their regulatory requirement will reflect this directive once it comes into force.

#### **Implementation**

77. FSA conducted a survey of life insurer's risk management practices in October 2003 and noted that their guidance and proposals have, to some extent, been implemented within this sector of the insurance industry. They have highlighted

however that most of the changes firms have introduced to their practices have been done in a reactive rather than proactive manner, following the guidance rather than understanding what is required and not looking closely enough at their own existing systems before instigating the changes. Firms are increasing their levels of modelling activity, taking on external assistance where necessary. They have indicated though that communication between certain functions within firms has not improved and this could result in unsuitable modelling scenarios, which could hinder alignment of risk with capital. On the whole, it appears that their ever-evolving guidance has been welcomed and adopted by firms in general, but FSA note that they still are concerned that measures introduced are not implemented solely to meet compliance requirements.