

**PART IV: GOVERNANCE AND AUDIT****CHAPTER 9: CORPORATE GOVERNANCE**

1. The chapters on lifting the veil and on reporting obligations have aimed at explaining Equitable's realistic financial position in comparison with its published position and at explaining how its accounts were prepared and published without disclosing factors material to an objective assessment of the Society's state of affairs. In particular, I have sought to identify the excess allocation of bonus to policyholders over available assets that contributed to the need to reduce policy values in July 2001, and pointed to residual weaknesses in the Society's financial position. In this chapter I shall explore the background further to expose the managerial structures and policies that allowed the position to develop.

2. In looking at the governance of the Society, there are some issues to be borne in mind. The Society has at all material times been an unlimited liability mutual company. As a mutual, its with-profits policy values are a function of its assets less prior creditors' claims. Unless its assets were to fall below the level of its un-subordinated liabilities to third party creditors, that is creditors other than as with-profits policyholders of the Society or creditors subordinated to with-profits policyholders, it could not become insolvent in any absolute sense. The risk of the Society trading while insolvent in these circumstances was remote. The directors at all times had the right to cut policy values in the with-profits fund to reduce the aggregate liabilities of the Society to the level of its available assets. The timing of such a step would have been critical to policyholders as a whole and individually. The Society could have become technically insolvent in a regulatory sense well before it reached a state of absolute insolvency, and that would have been the more likely occasion of external intervention in its affairs. Regulation of the Society is discussed later. But for the present it is the internal management of the Society's financial affairs that must be the focus of attention.

3. It is also important to bear in mind the risk that concentration on the Society's global financial position may divert, and in the past might well have diverted, attention from the impact of management decisions on groups of policyholders and on individual policyholders at the point of investment and on claims. An overview of the business must not ignore the consequences for those directly affected. Equally, concentration on one cohort of policyholders, for example those whose policies were about to mature, to the exclusion of those who might be expected to remain participants in the funds over a longer term, could also affect adversely the fairness of the decisions reached..

4. The implications for policyholders can be illustrated by reference to the case of a retirement annuity or personal pension policyholder approaching maturity. Until the policyholder reached pension age, he would have remained a with-profits policyholder and a member of the Society. His policy value would have been vulnerable to any cut announced by the directors. On the day he reached pension age, had he taken no fresh initiative, his benefits would have crystallised, and become a fixed liability of the Society. Prima facie the policyholder would immediately be protected, by the emerging contractual liability, from vulnerability to cuts in total policy values. But the policyholder would have been confronted by choice. He might exercise the open-market option and take his benefits elsewhere, divorcing his future financial interests from those of the Society. He might take his contractual rights. The annuity would begin to run, wholly or substantially backed by fixed interest securities. He might exercise the commutation option, and otherwise take the annuity secured by the contract. He might elect to transfer into a with-profits annuity and become again vulnerable to policy cuts. He might exercise any of the alternative benefits options specified in the contract. The directors' decisions could not properly be focused on an analysis of the fund that failed to take

account of the multi-faceted nature of the policyholder's problem in dealing with a complex product.

5. The Board of Equitable would have owed duties to the particular policyholder, to all those already in pension before him, and to the body of continuing policyholders who remained in the with-profits fund at his departure, as well as those who might join thereafter. Those duties would have been expressed in part in the Board's duties in the exercise of powers under the articles of association to determine the levels of bonus payable to policyholders generally, the maturing policyholder in particular, and the body of continuing policyholders whose interests would be affected by actions taken relative to the benefits of the departing member. The arrangements made for the due recognition and performance of the Board's duties in these areas are topics of importance in the present discussion. These would not exhaust the overall responsibilities of the Board. The effectiveness of governance has to be considered in a wide context.

6. This chapter is concerned with the arrangements in place for governance of Equitable over the period of the inquiry's interest in respect of the recognition and quantification of policyholders' rights. Some issues may have a wider relevance, for example the problems associated with unlimited liability mutual assurance companies carrying on long-term business. But essentially the discussion is focused on the Society, and in particular on the delegation of areas of responsibility to the Society's actuary and actuarial staff. There are current proceedings in the High Court between the Society and some of its former directors and auditors. It is not for the inquiry to offer views on any allegation of breach of duty that has arisen, or may yet arise, in civil proceedings. But it would be impossible to provide a complete account of the financial history of the Society without discussing the respective roles of management and the Board over time in relation to policyholders' rights and the Society's corresponding liabilities. Whether the circumstances narrated might support a conclusion of breach of duty, or provide exoneration from any such breach must be left to others.

### **Applying general principles**

7. The Cadbury definition of corporate governance<sup>1</sup> provides a convenient starting point for the discussion:

“Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting.”

A statement generally to the same effect could have been made at any time during the period of interest. However, it is immediately apparent that the definition, adequate where the entity's shareholders and customers are not identified with each other, does not capture the relationships peculiar to a mutual life company, and in particular the fact that, in the case of mutual with-profits business, the persons with whom business is done are the persons for whom business is done.

8. Cadbury reported against a background of developing law both in relation to the collegiate responsibility of boards and in relation to the individual responsibility of directors. In relation to individual responsibility changes were more far-reaching. In *Bishopgate Investment Management Ltd v Maxwell (No 2)*, Hoffmann LJ said:

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<sup>1</sup> The Financial Aspects of Corporate Governance (the 'Cadbury Report'), paragraph 2.5.

“In the older cases the duty of a director to participate in the management of a company is stated in very undemanding terms. The law may be evolving in response to changes in public attitudes to corporate governance ...”<sup>2</sup>

The standards demanded of directors individually at the end of the twentieth century and beginning of this century cannot be applied uncritically to earlier periods. It would be particularly inappropriate to apply current and emerging standards in judging the conduct described in this chapter of the report. But it is legitimate to use those standards to explore the lessons to be learned for the future from the events of the past.

9. Fixing bonus levels for with-profits policyholders was a central element of the range of duties imposed by the articles of association of the Society on the directors. It is clear that balancing the interests of successive generations of policyholders of the same class, and balancing interests among the classes at any time and over time, imposed obligations on the Board as a whole, and on the directors individually. The members were all policyholders of the Society, but the reverse did not hold true: certain policyholders might never be members, and some might relinquish the status of member while the contract that sustained membership subsisted. The directors’ obligations were wide-ranging.

10. General comments on corporate governance would be beyond the scope of this report. The Cadbury Report, Hampel’s Principles, the Combined Code of May 2000, and the Greenbury recommendations on remuneration were taken into account by Equitable, though they were applicable strictly to listed companies, and some reference to these materials will be unavoidable. But it would be inappropriate to comment more generally. The comprehensive studies of the Law Commission of England and Wales and the Law Commission of Scotland<sup>3</sup>, the report of the Company Law Review<sup>4</sup>, and the white paper Modernising Company Law<sup>5</sup> set out the nature and extent of directors’ duties and responsibilities as developed in the common law and current legislation, the analysis of present thought, and proposals for future developments in legislation and self-regulation. These have been followed by the Higgs<sup>6</sup> and Smith<sup>7</sup> reports among other developments in thought and practice.

11. Within this body of work, the position of unlimited liability mutual societies has not received in-depth treatment. However, among the dwindling number of surviving mutuals are companies of major economic significance in the financial sector, handling the public’s savings, and in particular savings for their future pensions. By definition, mutuals have no shareholders. The nearest equivalent interests are those of with-profits policyholders or some class or classes of those policyholders. In the case of Equitable, as I will discuss below, the relevant classes of policyholders had no material role in governance

12. Underlying the provisions proposed in the Company Law Review is a structure in which one can identify members’ interests, customers’ interests, suppliers’ interests and society’s interests, and contemplate the extent to which it is possible to achieve a balance among them. In the case of a mutual life assurance society interests falling into each of the categories can be identified. The external physical and economic environment in which the office operates will not differ significantly from that of any proprietary office. The office will have relationships with suppliers of goods and services required for the conduct of the business. There will inevitably be

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<sup>2</sup> 1993 BCLC 1282 at page 1285.

<sup>3</sup> Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties: Consultation Paper 153, Report 173.

<sup>4</sup> Modern Company Law for a Competitive Economy: Final Report of the Company Law Review.

<sup>5</sup> Modernising Company Law, Cmnd 5553.

<sup>6</sup> Review of the Role and Effectiveness of Non-Executive Directors, Derek Higgs.

<sup>7</sup> Audit Committees: Combined Code Guidance, Robert Smith.

an interest in the office's reputation: sales depend on confidence. Fair outcomes as between members are inseparable from the business objectives of a life office.

13. But the relationship between the members and the company is unique. A basic characteristic of mutual business is the identification of membership of the company with the contractual relationship between the holders of participating contracts and the office already mentioned. Membership is typically defined in terms of participation in the profits or distributable surplus of the office. Non-participating contracts, for example a fully guaranteed policy providing a fixed obligation to pay a specified sum of money on a contingency, and linked contracts may not qualify the policyholder for membership. Policyholders may be members or may be creditors of the company or both, with those relationships arising from their policies and defined in the constituent documents of the office by reference to those policies. This makes the application of common rules and principles of governance difficult.

### **Formal structures**

#### **Policyholder Role in Governance**

14. Subject to limited qualifications, Equitable's articles defined a member as a person who had effected a policy that at the material time entitled that person to participate in the profits of the Society. The holder of a non-profit policy did not qualify for membership, nor did the holder of a unit-linked policy. The proportion of the total range of policyholders that qualified for membership at any one time would depend on the classes of business that had been sold and remained in force at the time. The qualifying class would of necessity be the members of a fluctuating group of policyholders identified primarily by the terms of their contracts with the Society, for the time being, and only secondarily in terms of the constituent documents of the Society. They would enter the class, qualify for membership rights, see those rights change with time, and ultimately leave the class, their position throughout determined in terms related to investment of contributions, accrual of benefits, and maturity or surrender of benefits under their contracts with the Society.

15. Thus their status could change while they remained in contractual relationships with the Society controlled by the sale contract. For example, a contract for a deferred annuity might participate in profits until maturity when it would provide for payment of an agreed or calculated annual sum until death. At that point the policyholder would cease to enjoy the benefits of membership. There would, in that case, be a material change in the economic relationship between the policyholder and the office under the same contract. Ignoring insolvency, crystallisation of benefits would insulate the policyholder from future fluctuations in the office's performance and profitability. But differences between policyholders qualifying for membership rights, or full rights, and those failing to qualify might be less clearly based on economic rights. For example, voting rights were limited to members with £1000 of sum assured.

16. The Society, by definition, had no share capital. The aggregate of members' particular qualifying rights constantly changed, and was known only to the Society at any given time. The ability of the members of Equitable to influence the conduct of business of the Society was therefore limited. With the exception of the ordinary recurrent business of the annual general meeting, all business was treated as special or extraordinary, requiring special notice and, typically, an extraordinary general meeting of the Society<sup>8</sup>. The prospects of any member or group of members obtaining the information necessary to assess whether or not a competent requisition could be framed and deposited were so remote that one can dismiss them as of no practical significance. In contrast to the register of members of a company limited by shares, where one might reasonably expect to find more or less accurate data on membership and shareholding, the policyholders' master file of a

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<sup>8</sup> See articles 8 and 24, and section 368 of the Companies Act 1985.

life office is not accessible to members, and, even if it were, in modern circumstances it would require sophisticated software to interrogate the computer on which it was held and extract relevant data. Without access to such data a requisition could not be proposed except on a speculative basis. If a pressure group sought information from like-minded members to support a requisition, it could never ascertain from its resources how the participants' voting rights related to the aggregate voting rights of other members at any one time.

17. For all practical purposes, the scope for raising special business at an extraordinary general meeting of the company depended on the initiative of directors. Members could propose and vote on the appointment of directors. There is no evidence that that right could be exercised effectively, other than in support of the proposals of the directors. But members could have no practical say in the management of the Society's business.

#### Directors' Role in Governance

18. Management of the business was committed to the directors, subject to certain prescriptive functions reserved to the Actuary. The principal provisions were widely drawn in the articles<sup>9</sup>. The directors had wide powers of delegation to the Actuary of the Society and to committees of the Board, and, in the case of duties imposed on or entrusted to the Actuary by the Articles, to others<sup>10</sup>. Delegation to the Actuary of powers exercisable by the Board might be subject to conditions, and was liable to revocation, withdrawal or variation by the Board. There were similar powers to revoke any delegation of power to a committee. In terms of statute, the appointed actuary of the Society, who might or might not be the Actuary appointed in terms of the articles, had independent responsibilities to regulators and relative rights that were not amenable to the directors' control. But all the powers of the Actuary derived from the Board were subject to revocation, withdrawal, alteration and variation. Delegation did not relieve the Board of its responsibilities. The provisions for revocation and variation in particular required active monitoring of the exercise of delegated powers if the Board were properly to manage the business.

19. Such wide powers of delegation raise important issues for the future. In their joint report, the Law Commissions concluded that there should not be a statutory provision setting out the circumstances in which a director might delegate his powers to others and rely on information provided by others without incurring liability<sup>11</sup>. The report recognised that a director might delegate matters to an employee of the company where the articles of association permitted it, and the needs of the business required it, in the absence of grounds for suspicion; and that a director might need to rely on information provided by employees and others<sup>12</sup>. This would be particularly relevant in a life office where actuarial judgment and advice would inevitably be required to inform directors' decisions. But the report stated:

“The courts in this country have ... recently had to consider the responsibility of a director who delegates. In *Re Barings plc* Sir Richard Scott VC confirmed that the overall responsibility of a director is not delegable. He said that the degree of personal blameworthiness that may attach to the individual with the overall responsibility, on account of a failure by those to whom he has delegated, must depend on the facts of each particular case. For example it might be that personal responsibility would attach because the system in which the failure occurred was inadequate. Similarly, in *Re Westmid Packing Services Ltd* Lord Woolf MR said that each individual director owed duties to the company to inform himself about its affairs and to join with his co-directors in supervising and controlling them. A proper degree of delegation

<sup>9</sup> Articles 54 and 55.

<sup>10</sup> Articles 46, 47, 58(1) and (4).

<sup>11</sup> Law Commissions Report 173: paragraph 5.37.

<sup>12</sup> Law Commissions Report 173: paragraph 5.30, footnote 37.

and division of responsibility was of course permissible, and often necessary, but not total abrogation of responsibility.”

The common law is developing to react to the changing demands of society and it was said that matters could be left to the courts. Against this background it is important to look at what happened at Equitable and to consider whether there are lessons to be learned for the future.

#### Composition of the Board

20. Until 1967 the Board of Equitable Life excluded current executives of the Society, including ‘the Actuary and Manager’, from appointment as director. When Henry Tappenden retired from office as Actuary and Manager he was appointed executive director, and retained some executive duties. This marked the first departure from established practice. In the following year Tappenden retired from all executive duties, but executive representation on the board was firmly established with the appointment of Maurice Ogborn, Tappenden’s successor as Actuary, to the Board in 1969.

21. From that time, executives came increasingly to take part in the direction of the Society. But it was to be some time before that was reflected in any fundamental change in attitude. Peter Martin, an experienced solicitor who was to become vice-president in time, told the inquiry that when he joined the Board at the beginning of 1984 it was his impression that the Society was governed very much by an old-fashioned “gentlemen and players” culture in the form that it had been since it was constituted in 1762 (the period was somewhat exaggerated). The Board consisted of City professionals with no specific life assurance expertise (mainly bankers and stockbrokers) who invested the premiums. There was little connection culturally between them and those executives who were based in Aylesbury. I accept his assessment as reliable. The role of the Aylesbury office was wide, and included management of the sales force, product design and administration, and the actuarial valuation of the liabilities and provisions that quantified the long-term fund and, by comparison with the assets of the Society, the surplus available for distribution.

22. Tappenden was one of two directors who retired from the board at the AGM in 1972. They were replaced by Barry Sherlock and the investment manager, Anthony Passmore. With Ogborn’s retirement in October that year, Sherlock was appointed general manager and actuary, and Roy Ranson became deputy actuary. There was a further major change in board membership in 1976, with three new appointments, each of whom was to play a significant part in the Society’s affairs, Professor Roland Smith, Alan Tritton, both non-executive directors, and Ken Wills, who was the marketing manager. Through the late 1970s and early 1980s, there were generally three executive directors in a board of ten or eleven.

23. In the president’s report presented at the annual general meeting in 1982, it was reported that Ranson had been appointed joint actuary (with Sherlock), and, with effect from 1 January that year, appointed actuary in succession to Sherlock. Ranson was appointed a director on 1 January 1985, following Passmore’s retirement in 1984. Wills retired in 1986. Thus the report and accounts for 1986 presented at the annual general meeting in 1987 reported nine directors, of who two held executive office, the joint actuaries Sherlock and Ranson.

24. On 1 January 1989 three new executive directors were appointed: Roger Bowley (company secretary), Shaun Kinnis (marketing director) and David Thomas (investment director). Of the twelve directors at the annual general meeting in 1989, five held executive office. At what was to prove the beginning of a critical period in the Society’s history, the balance of influence on the board had changed: though still a minority, the executive directors now constituted a significant force on the board. The Society’s business was evolving at the time into the modern form that was to continue throughout the remainder of my reference period.

25. By the time these appointments were made, it was Martin’s impression that the character of the Board had changed. There was movement towards creating a

modern Board that operated as a single cohesive body. The “gentleman and players” culture was breaking down. Non-executive directors were drawn from a wider background, and there were efforts to bridge the cultural divide. According to Martin, the Board began to be more cohesive with the appointment of Roland Smith as president in 1986. Smith, who has since died, apparently acknowledged limitations in his understanding of the financial side of the life business, but was keen to understand better how it worked in business terms, and on his initiative the Board gradually began to get much better information. They began to see more clearly how the Society was operating month by month. Again I accept Martin’s assessment as reliable. It is not immaterial that it was only in and after 1986 that the Board began to get management information of the kind Smith required. However, the Aylesbury factor continued to make an impact. The Board received additional information about the current management of the Society. But it remained dependent on the actuaries for technical management, and in particular for the critical elements of product development and liability valuation.

26. At the annual general meeting in 1994 three directors retired: Professor Sir Roland Smith, Sir Christopher Wates and Barry Sherlock. John Sclater was appointed president. At the annual general meeting in 1995, Sclater had a board of thirteen, of whom five held executive office (Alan Nash having been appointed in April 1993). However, there was a further significant change to the composition of the board in 1997, with the retirement of Ranson and Kinnis (both 31 July 1997) and Bowley (retired on 31 December 1997, but retained executive office). Two senior executives at the level below the Board also retired at this time, and the inquiry has seen some evidence that this transition was a fractious affair. At the annual general meeting in 1998 the Board had reduced to eleven members of whom two were executives: Nash and Thomas. That remained the position at the following year.

27. Over a critical period at the end of the 1980s and into the 1990s there was a strong executive presence on the Board. Until 1997-98, and the reduction in executive directors under Sclater’s presidency, executive influence on the Board had grown from insignificant until, especially under Sir Roland Smith, it had become a material force, stabilising at about five out of a fluctuating total of around thirteen to fourteen directors.

#### Committee structure

28. Over time, the Board established committees, some of relatively short duration and some longer term or even permanent. There was a new business committee in the 1970s when achieving growth was a primary concern of the Board. There was a long-standing investment committee. There was a nominations committee. Later there was a remuneration committee. In and after 1994 there was an audit committee. But a substantial part of the actual business of the Society was delegated to the executive.

29. The actuarial department had substantial control of product design, and, critically, liability valuation and related matters. The actuarial department was intimately involved in investment policy formulation. Marketing was effectively delegated to the marketing director and his staff, subject to report. The actuary of the Society appointed in terms of the articles of association was not necessarily leader of the Aylesbury actuarial department. Ogborn appears to have controlled the actuarial function and operated as chief executive. Sherlock progressively delegated the actuarial function to Ranson, concentrating in the London office on general management issues. By the end of the 1970s and early 1980s Ranson had become the single most powerful executive of the Society. He became appointed actuary in 1982, and his position was consolidated when he became a director in 1985. He held jointly the offices of managing director and appointed actuary between 1 July 1991 and 31 July 1997. But his influence and authority were established long before that time.

30. From the discussion of the developing bonus policies of the Board from the early 1980s onwards<sup>13</sup>, it appears clearly that the Board's dependence on actuarial advice was total. None of the non-executive directors had relevant life office experience, or relevant qualifications. The heavy concentration on investment matters reflected the interests and expertise of the majority of the non-executive directors. They were not equipped to challenge actuarial advice, and it appears that they were advised and accepted that that was not their role. In practice the actuary provided the board with a great deal of written material and oral explanations of the management of the business and of the decisions that had been taken. The Board asked questions and received explanations. But, critically, there were few decisions. In relation to valuation, the quantification of surplus, and the allocation of bonuses generally, the Board was almost totally dependent on the actuary for information and for advice. It was in relation to this area that delegation was seen to operate most comprehensively and to remain unquestioned.

#### The Appointed Actuary

31. On 24 August 1977, the Board was presented with materials relating to the appointed actuary's role. The minutes record receipt of a letter from the Department of Trade stressing the need for the appointed actuary to be provided with sufficient information on a continuing basis to discharge his responsibilities and reminding offices that it would be a matter of concern to the department if it appeared that decisions of significance to the interest of life policyholders had been taken and implemented without the appointed actuary being given an opportunity of commenting, or if the decisions were contrary to his advice. The letter enclosed the terms of a reply to a question in Parliament and the Institute of Actuaries guidance note for appointed actuaries. It communicated effectively the intention of regulators at that time that the appointed actuary should have a central role in the formulation of policy.

32. The statement in Parliament had underlined the need for the appointed actuary to have continuous access to relevant information, and lent authority to the professional guidance note. But the professional guidance did not remove from the board of directors of life offices the responsibility they had for the conduct of business: rather it underlined and supplemented those responsibilities. It stated that responsibility for company decisions must, in law and in practice, rest with the board of directors. But the emphasis placed on these statements by the Equitable Board tended to convey the impression that the appointed actuary in particular had a predominant role as a director in relation to matters that fell within the area of his responsibilities as appointed actuary, though that was not consistent with the tenor of the note. In reporting to the Board, the appointed actuary drew attention to his position as such in making recommendations and tendering advice.

33. The guidance, correctly in my view, emphasised the role and responsibility of the board of directors of life companies, and the role and responsibilities of the appointed actuary in that context. Where the appointed actuary was a director of the company, he had all of the obligations to the company and to co-directors that any director with special qualifications would have. The statutory responsibilities were additional to that.

34. The duties of the appointed actuary were spelled out in the professional guidance note. It was said to be incumbent on all appointed actuaries to ensure, so far as was within their authority, that long-term business was operated on sound financial lines. It observed that every actuary acting in his professional capacity had a duty to his profession. The appointed actuary was said to be in a special position in that he was appointed and remunerated by the company, and at the same time had responsibilities and obligations to the Department of Trade by reason of his statutory duties, which arose from the department's supervisory functions aimed at the protection of policyholders. In relation to the company, the appointed actuary

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<sup>13</sup> See Part II to this Report.

had duties to give advice in relation to his statutory duties. Within the scope of those duties, the appointed actuary was privileged. Paragraph 8.3 of the guidance note stated:

“A special responsibility is owed to the appointed actuary by any other actuary who is a director. He can be of great use both to the board and to the appointed actuary, in assisting the board to a full understanding of actuarial issues. He should be careful not to act in such a way as to diminish the status of the appointed actuary.”

35. The official statements were concerned to ensure, so far as encouragement could achieve it, that boards of directors and chief executives provided the appointed actuary with the information required to assess the on-going financial health of the office, to understand the terms and conditions applying to new contracts, to understand the investment policies of the office, and to understand its marketing strategies. In the case of Equitable these matters were largely either the business of ‘the Actuary’, who was not necessarily the appointed actuary, or materially influenced by him. At all material times Ranson had de facto executive control of the relevant areas of business.

36. The official statements were general in scope, and were intended for companies with a wide range of governance arrangements in which the person for the time being holding office as appointed actuary might, at one extreme be chief executive and at the other a technical officer who was not a director. They had more relevance to companies in which the appointed actuary did not have direct control of the sources, or most of the sources, of relevant information. Sherlock was at the time general manager and actuary in terms of the articles, and appointed actuary in terms of the statute. Ranson had control of the actuarial function at Aylesbury, and in 1982 succeeded to the position of appointed actuary. When the 1982 Act came into force, he was also reporting actuary for Companies Act accounts purposes. The Society was far from the model assumed in these original forms of guidance. But reliance on the official statement, and on the joint professional bodies’ statement, served to emphasise the predominant position of the actuaries in relation to the areas of responsibility they had.

37. Successive editions of GN1 and GN8 modified and developed the guidance as originally set out in these documents. However, for present purposes it is sufficient to note the underlying assumptions as to the relationship between the appointed actuary and the board that they reflected.

38. The paper *With Profits Without Mystery*<sup>14</sup> described the role of the actuaries of the Society as follows:

4.4.1 It will be evident ... that for the successful application of a concept such as the with-profits managed fund, there needs to be a high level of actuarial involvement across all aspects of the business. It is, perhaps, not surprising that the concept has developed in our office which has a long tradition of strong actuarial control running back to William Morgan. That control is not applied in a limited technical way but in an outward-looking positive manner designed to foster the commercial success of the organization. We believe that actuaries have unique insights into the operation of life offices which make it vital they should play a central part in running those institutions. Recent proposals to strengthen the position of actuaries in organizations where their role has been less central are therefore to be welcomed, but there is, perhaps, scope to develop actuarial attitudes so that offices see the gains to be obtained in involving actuaries fully in their businesses. We fully agree with Redington's well-known comment that "an actuary who is only an actuary is not an actuary.”

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<sup>14</sup> See chapter 4.

### The Society's published position on corporate governance

39. The directors' report in the report and accounts for 1994 contained a statement on corporate governance. In it the directors acknowledged their responsibility for establishing and monitoring the effectiveness of the system of internal control used in the Society and the Group, the objectives of which were said to be to provide reasonable assurance of effective and efficient business operations; the safeguarding of assets; control of transactions; the maintenance of proper records and the reliability of financial information used within the business or for publication; and compliance with laws and regulations. It stated that in assessing what constituted reasonable assurance the directors had regard to the materiality of any financial risks incurred, the likelihood of such risks crystallising and the cost of and benefits from particular aspects of the internal control system.

40. In relation to the accounts, it was acknowledged that it was for the directors to select and apply suitable accounting policies; make reasonable and prudent judgments and estimates; state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the accounts; and to prepare the accounts on the going concern basis unless it is inappropriate to presume that the Group would continue in business.

41. A more extensive statement appeared the following year, 1995. It stated that the Board considered that the Society met in all material respects the spirit and approach of the Cadbury code of best practice. In substance it made the same representations about the scope of the directors' responsibilities as the 1994 statement. It gave full details of the committee structure.

42. In 1996 the president's statement to members on corporate governance was relatively brief. But the Board pinned its colours firmly to the mast in the directors' report and represented to members and the public at large that its procedures complied with the current codes of conduct in all material respects. There was an extended statement of the position in the directors' report in the annual accounts. The statement defined the role of the audit committee strictly in terms of the Board's responsibilities for the accounts and for the accounting policies of the Society, the contents of annual reports and accounts, the conclusions drawn from internal control reports and the adequacy and scope of the audit. Internal control was the ultimate responsibility of the directors, and extended to establishing and monitoring that the Society had in place an appropriate system of controls, financial and otherwise, to provide reasonable assurance with respect to:

- the business being operated efficiently and effectively;
- the safeguarding of assets against unauthorised use or disposition;
- the maintenance of proper records and the reliability of financial information used within the business or for publication;
- compliance with laws and regulations.

It was stated that in assessing what constituted reasonable assurance, the directors had regard to the materiality of any financial risks incurred, the likelihood of such risks crystallising, and the cost of, and benefits from particular aspects of the internal control system. The effectiveness of the system of control was said to be reviewed regularly by the Board.

43. The presentation changed in the 1997 accounts, but in substance the message was the same. In the 1998 account the president's statement and the directors' report stated that the Society was committed to integrity and professionalism in all its activities, and that as an essential part of this commitment the Board pursued the highest standards in corporate governance. They confirmed that the Society had voluntarily adopted the Combined Code appended to the listing rules of the London Stock Exchange. Limited exceptions from compliance were noted. The scope of the audit committee's remit as published remained the same as previously published, as did the directors' responsibility for internal control.

44. In the 1999 Accounts, the Society's adherence to the Combined Code was repeated. The scope of the audit committee's remit was altered to include risk management and internal controls. The directors' report restated the directors' position on accountability and audit. It repeated the statement of the directors' responsibility for internal control for the Society and the Group, and made comments on the requirements and limitations of a sound system of internal control. It acknowledged the directors' responsibility, in terms of the Combined Code, to review the effectiveness of the Society's and the Group's system of internal control, including financial, operational, compliance and risk management controls. It set out the steps taken during the year to review the effectiveness of the existing system, and outlined the main elements of the Society's control framework. These included:

- A report on the results of the annual valuation by the appointed actuary.
- A risk management group (RMG), which assisted the Board in identifying, managing and controlling risk.
- Regular review of significant control issues by the Audit committee, which received reports from management and from the RMG as well as from the Society's external auditors.
- An annual risks and controls self-assessment undertaken by management, the results of which were considered by the RMG and the audit committee.

The position reflected material developments. The 2000 accounts reflected a similar position, though now having closed to new business, the report took account of that reality.

45. The developments presented in the Society's published financial statements reflected the response to external developments in the recognised requirements of good corporate governance, and processes of development and change within the Society. As earlier discussion has shown, the Board's understanding of the annuity guarantee issue was at best limited until the autumn of 1997, and some directors may not have had any understanding of the position. The guarantee issue was an aspect of liability valuation. It is primarily in that context of liability valuation that one must consider the internal developments and seek answers to the questions that arise from the apparent failure of the Board to identify and to react to the risks confronting the Society as a result of its valuation and distribution policies.

#### Management of Risk

46. Risk management, in the most general terms, began to emerge as a significant issue in the early 1990s, initially on a limited basis. In 1992 the auditors advised that, with the Society's growth and the ever-increasing size and complexity of its operations, there was an increasing risk of error or fraud remaining undetected. They proposed an independent systems and controls review or internal audit function as possible solutions. They said that they understood that the Society might be considering an independent systems and controls review function and commended that course.

47. In response, in a paper dated 23 September 1992, Ranson wrote:

“The Society is currently considering how to achieve the general objective of ensuring compliance with agreed operating standards. Endorsing this objective and noting actions taken to date, the auditors recommended the formation of a system and controls review function. We are considering this recommendation whilst remaining committed to achieving our objective without materially increasing costs or diminishing the accountability or responsibility of local managers.”

A management group was envisaged rather than a committee of the Board.

48. The new unit was set up. The terms of reference were approved by Ranson on 8 February 1993. The unit was to operate strictly within the current management

control system. On 10 February 1993 Ranson issued a memo entitled 'Systems and Controls Review', which said that the unit was to cover all aspects of the Society's UK operation, except those areas covered by the compliance officer. Members of the unit were to have access to whatever information or explanation they considered necessary to fulfil their responsibility, including access to any record, personnel or physical property of the Society (although certain information might be restricted to the unit's manager only).

49. In comments to the other senior executives, Ranson treated this as a personal project. The terms of reference for the unit were circulated to senior executives on 17 February. They were:

**"Role and Purpose of the Systems and Controls Review Unit**

Systems and Controls Review is an independent appraisal function, established within the Society, to monitor the operation and effectiveness of systems and control procedures, pointing out, wherever possible, those that appear inadequate.

**Primary Purpose**

To make the Society more effective and cost efficient by way of: providing a service to all levels of the Society's Management in relation to ensuring compliance of the various parts of the organisation to:

- a) Society policies, as laid down by the Board of Directors;
- b) Internal procedures, methods and standards set by Senior Management;

**Secondary Purpose**

To assist all levels of the Society's Management by way of: pointing out procedures, methods and standards which appear inadequate for the purpose, assessing risks and recommending possible courses of action."

The terms of reference were to be reviewed annually to confirm that the document continued to be accurate and up-to-date. There is some evidence that the unit was an answer to pressure from some directors for an internal audit system that Ranson did not want.

50. The unit was given wide authority:

"In carrying out its duties and responsibilities the Review Unit has full and unrestricted access to all the Society's U.K. activities, records, property and personnel, (except that its scope does not encompass Compliance matters)."

The objective of the unit was to ensure compliance with the Society's internal systems. Responsibility for the unit's operation was placed firmly with the general management team (GMT), a team of the Society's most senior executives. A strategy document for the unit listed a number of possible areas for review in 1993. These included "all aspects" of reinsurance and "determining amount due, and the paying of – annuities, maturities, surrenders and underwriting (all aspects)". The remit covered generally salaries, purchasing procedures, computer equipment, cars, general office equipment, stationery and printing materials, cash control systems, and other matters.

51. On 26 August 1993 Ranson distributed a further memorandum to general managers and senior managers, taking matters further. He observed that it was for the GMT to decide which risks facing the Society were acceptable and which needed attention. He said that the Society had formulated various basic principles of operation aimed at combating unacceptable risks. But the combination of growth and mechanisation made it timely to address the issue, and the GMT would be reviewing the areas of control where risk was perceived to exist. He identified members of the executive team who would be involved.

52. The auditors' suggestion of an internal audit function had been rejected. The inquiry has been informed that it had been rejected by Ranson. The unit, to become known as the Systems and Controls Review Group or SCRG, had a wider remit than envisaged in the auditors' management letter. But its involvement in the actuarial area of management was limited. It was concerned, for example, with the implementation of benefits payments, not the determination of liabilities or surplus or the allocation of bonus, nor with the risks associated with these factors. The SCRG was not given an internal audit function. Ranson considered that to do so would create expectations as to its activities and place in the organisation that would be not be relevant to its role. Julian Hirst, the Society's chief accountant at the time, told the Inquiry that "The remit was different to that of an internal audit function – its remit was to ensure compliance with office principles and policies and to assist management".

53. The group took up the work and produced substantial reports, for example a report on investment procedures and controls circulated in draft for comment on 1 March 1995. Within the scope of its remit, a great deal of work followed the setting up of the unit in this and other areas in 1994 and 1995. But the limitations on its remit had practical consequences. The group did not assess policy in the context of the Society's general aims. It did not have the role of ensuring that procedures were being complied with: that was the job of managers. It could not follow up issues that might involve risk, since it was not to "provide solutions".

54. Meantime, the Board established an audit committee in January 1994. It met on 26 January 1994. At that date the SCRG was dealing with areas that might otherwise have been seen as the province of the Board's audit committee. The corporate governance statements in the 1994 and 1995 accounts could have given the impression that the SCRG remit was a Board rather than a management function. The Cadbury Report on corporate governance had been published two years earlier. The Society was not a listed company and was not obliged to set up an audit committee, in adherence to the Cadbury rules. However, from witness evidence, it appears the executive came under pressure from the Board to comply with Cadbury. There was a desire on the part of the Board to present the Society as a modern company, conducting its business in line with the latest thinking and decisions on governance. The approach reflected a growing appreciation of the need for the Board to play a more central role in relation to the Society's business as a whole.

55. Hirst told the inquiry that non-executive directors were familiar with governance in the general market place, and that there was pressure to have an audit committee and some sort of audit function. Internally it was felt that, whilst the listing requirements didn't apply, Equitable was a public interest company and went out to demonstrate corporate governance on this basis. He suspected that some executives would have been less happy about the proposal on the grounds that it was thought to undermine management's responsibilities. "It was against the ethos of the Society."

56. The Society's ethos was reflected, typically in my view, in the informal arrangements for contact between the executive management and senior members of the board. According to Hirst, the president and vice presidents were invited by the executive to an annual lunch with the external auditors on completion of the audit in early March. Apart from this, there was direct reporting to the Board on actuarial and related matters without the intervention of any committee.

57. Despite Ranson's apparent reluctance to set up an audit committee, in January 1994 he wrote the instigating and defining document for its existence. The purpose of the document was said to be to "consider the need for and to make recommendations regarding the formation of an Audit Committee to the Board". It reviewed past practice and commented on the "potential pitfalls" as well as the benefits of having an audit committee.

58. The desirability of establishing an audit committee was attributed to the growth of the Society, and the need to provide comfort, through a process of independent and objective review, that financial reporting and control were operating correctly. The comfort was said to be for directors, and particularly non-executive directors, reflecting the provenance of the pressures to set up the committee. However, there was a “fine line between an effective oversight role and the responsibility of management to manage the business” and Ranson warned that an audit committee could not relieve the Board of its collective responsibility for financial reporting and control processes, and:

“It is also essential that an audit committee should not stand between the auditors and the executive directors or in any way inhibit access by the auditors to the full board.”

The answer, he said, was to ensure that the committee was properly constituted.

59. On 26 January 1994 the Board approved terms of reference for the audit committee. The main duties of the committee were set out in Ranson’s paper:

- “a) To review the Report and Accounts before submission to the Board, with particular regard to:
  - i. Any changes in accounting policies and practices.
  - ii. Major judgmental areas.
  - iii. Significant adjustments resulting from the audit.
  - iv. The going concern assumption.
  - v. Compliance with accounting standards.
  - vi. Compliance with legal requirements.
- b) To discuss problems and reservations arising from the audit, and any matters the external auditor may wish to discuss.
- c) To review the external auditor's management letter and management's response.”

These remained the committee’s terms of reference until 1996.

60. Revised terms of reference were adopted on 24 April 1996. The revised format defined the objectives of the committee as ensuring that the financial systems provided accurate and up to date information on the Society and Group financial position and that published statements represented a true and fair reflection of this position; that appropriate accounting policies and internal controls were in place; and that the Society met in all material respects the spirit and approach of the Cadbury and Greenbury Codes. The committee was authorised to investigate any activity within its terms of reference; to seek any information it required from any employee related to any matter within the committee's terms of reference; to obtain any relevant legal or accounting professional advice; and to invite outsiders with relevant experience and expertise to attend meetings if it considered this necessary. The duties, (a), (b) and (c), set out in the 1994 terms of reference were repeated. In addition, the committee’s remit extended:

“... ”

- d) To consider, at a high level, other topics likely to be of relevance to the Report and Accounts of the Society.
- e) To consider the appointment of the auditors, including terms of engagement, and the audit fee.
- f) To discuss with the external auditors before the audit commences the nature and scope of the audit.

- g) To review the statutory returns to the Department of Trade and Industry before submission to the Board.
- h) To receive reports from the Systems and Controls Review Group, including an annual report on the major reviews undertaken in the previous year and those planned in the future; and to receive reports or specific topics commissioned by the Committee or by the Board for consideration by the Committee.
- i) To review the Society's current practices in relation to internal control, calling upon such reports as the Committee shall deem appropriate from management, the Systems and Controls Review Group and the external auditors. Thereafter to review the Society's statement on internal control (to be included in the Report and Accounts) prior to endorsement by the Board."

61. For present purposes, the significant additions, reflecting major changes in approach, and indicating the limitations of the 1994 remit, were (g), the review of the regulatory returns; and (h) and (i) that established a formal relationship between the audit committee and the SCRG, bringing that group's internal control functions into the audit remit.

62. The terms of reference were further extended and amended on 28 June 2000. As appears from the published financial statements, this formulation reflected decisions taken in 1999. The formal paper identified objectives for the committee: to ensure, firstly, that the published financial statements represented a true and fair reflection of the Society's financial position, and, secondly, that appropriate accounting policies and systems of internal control were in place. The committee was authorised, among other things, to investigate any activity within its terms of reference. This extended to the review of reports by management committees covering internal audit, compliance and business risk management and consideration of the cumulative assurance that could be derived on the operational effectiveness of matters related to risk and control.

63. Specifically in relation to risk management and internal control systems, the committee's remit extended to review of:

- š the overall framework, policies and processes established by management to embed an effective system of risk management and internal control, covering the nature and extent of the risks facing the Society and the Group;
- š the extent and categories of risk which the Board regarded as acceptable for the Society and the Group to bear;
- š the likelihood of the risks concerned materialising and the ability of the Society and the Group to reduce the incidence and impact on the business of risks that did materialise;
- š the overall culture and attitude towards control established within the Group and relevant aspects of third party service suppliers;
- š the business continuity plans and related testing of their maintenance and operation, covering the Society and the Group;
- š the timeliness of any corrective action being taken by management to manage risks or to address any shortcomings in internal control;
- š the costs of operating controls relative to the benefit thereby obtained in managing the related risks;
- š the policies and processes necessary for the Society and the Group to comply with their relevant regulatory and legal requirements, including taxation;
- š and, where directed by the Board, other matters such as the Society's and the Group's code of corporate conduct and business ethics.

64. In relation to the regulatory obligations of the Society and the Group, the audit committee's remit extended to the review of reports from management addressing:

- § the relationship with the Financial Services Authority (FSA) and other relevant regulatory bodies; the Society's and the Group's compliance with the Financial Services & Markets Act 2000 and related legislation;
- § the systems and controls established by management for compliance with the regulatory requirements as specified in the FSA handbook;
- § the culture of compliance within the Society and the Group, and other relevant third parties;
- § and the Society's and the Group's overall compliance position, having particular regard to FSA's annual regulatory themes.

65. In formal terms, the remit of the audit committee was altered and extended over the period that it existed. The 2000 edition had regard to the position that existed after the acquisition by Halifax of substantial interests in the Society's former business and the administrative arrangements put in place to deal with the residue of the business, the with-profits fund. Leaving aside the specific provisions required to deal with the new regime, significant developments included the review of the overall framework, policies and processes established by management to embed an effective system of risk management and internal control and compliance with regulatory requirements. Risk management in the widest sense had become an aspect of the audit committee's remit. And compliance with the new FSA regulatory regime increased the commitment of the committee to review of regulatory matters. In context, the 1994 committee had a restricted remit, excluding significant areas of management from review.

66. The decisions on establishing an audit committee and developing its duties did not proceed in ignorance of what was happening elsewhere. Hirst explored other offices' risk assessment systems. He obtained copies of the terms of reference of the audit committees at two other life groups from their group accountants. He referred to "the somewhat daunting task of 'managing risk'". He reported to Bowley on his findings to date on 1 February 1996. He reported that Scottish Widows addressed risk management as part of the responsibilities of their audit committee, and that they were in the process of introducing a very structured approach to managing risk. He referred to observations he had made in the autumn of 1995 that the boards of some offices were concerned about the nature and extent of the comfort which they required in relation to internal financial control and, accordingly, had commissioned wide ranging reviews of the control/risk management systems operating in their organisations. Equitable's 1996 review did not take such a radical approach. Not until 2000 was the remit widened to include risk assessment in full.

67. Management structures continued to evolve, and a number of groups came into existence in 1995 and 1996. The minutes of a meeting of one such group, the 'Control of Systems & Procedures Group', on 27 April 1995, disclosed that the SCRG was then reporting to it. It was noted that there did not appear to be a consistent approach to access controls. There did not seem to be a defined office policy. The minute stated:

"Central guidance on principles needed. Security of the controls is currently in the Management Services area; in other organisations it might more normally be part of the Audit function..."

Control should probably be in DCD's area (under guidance from the GMT). Detailed rules would be needed from the central group. Also monitoring would be needed."

The group made proposals for centralised control.

68. Co-ordination of the work of the groups dealing with security risks and controls was discussed in December 1995. Bowley was keen to bring more focus to

the work, and proposed that the 'Control of Systems and Procedures Group' and the 'Risks and Controls Group', which now incorporated the SCRG, should be amalgamated. In a memo from one of the constituents of the Risks and Controls Group supporting the proposal for amalgamation, it was observed that the latter group discussed important issues, but lacked any real structure or formal acceptance of its existence. The writer stressed the need to obtain approval from Ranson because:

“Without acceptance by RHR of what the group is trying to achieve, and how it plans to operate, an enormous amount of time would be wasted.”

The Securities Risks and Controls Group (confusingly the SRCG) was to be set up in response to management's wish to develop internal controls and the risk management framework, and to provide comfort to the audit committee in which Peter Davis (a non executive director and chartered accountant) in particular was concerned about the lack of accountability of the existing SCRG.

69. Proposals for the formation of the new group were taken forward in January 1996. The agenda for the first discussions incorporated extensive documentation. It explained the existing groups. The Control of Systems and Procedures Group had emerged from a review of payment authorisation procedures and had commissioned a study of risks perceived by line management. The Risks and Controls Group had been formed following SCRG reviews on "data" and risks. Neither group had written terms of reference. They appeared to overlap, but in total they failed to cover the relevant areas comprehensively. The proposal was formalised: that the two groups be joined with the object of discussing all aspects relating to security, risks and controls. This new group could report to the managing director and through him to the audit committee on its activities and findings. The proposals for membership reflected the range of its intended functions, which covered the company secretary's area, accounting, policy data and internal review (which meant the SCRG), individual business and international administration, actuarial areas and group business.

70. Meanwhile the position of the existing SCRG within the new arrangements was the subject of debate. There had been an objection to a topic selected for review by the SCRG. Driscoll, the assistant general manager who was responsible for the SCRG, responded on 26 January 1996. He was concerned to assert the independence of the SCRG from the new group. He argued that that was set out in its terms of reference and was also the basis of operation presented to and understood and effectively ratified by the Society's audit committee. (The implication was that the June 1996 terms of reference had already been adopted in practice.) It was critical to proper discharge of the duties of the unit. The unit was ultimately accountable on the one hand to Ranson and on the other to the audit committee. He argued that the existence of the new risks and controls group changed nothing as regards the independence of the function. He would not accept that it was appropriate for that group in effect to dictate what reviews would or would not be undertaken. He preferred co-operation between the two groups. It was a powerful assertion of the role of SCRG. But it did not divert the progress of the new proposal. The formation of the new group, the SRCG, proceeded.

71. The SRCG met on 5 February 1996. Bowley commented that the proposal for the new group followed the memo from Ranson to assistant general managers and senior managers dated 26 August 1993<sup>15</sup>, and the establishment of and reporting by SCRG. He commented on the need to be in a position to give comfort to the audit committee on relevant matters. The group could assist the GMT by providing material for decisions. SCRG would not be "constrained" by this group, but the new group would have the opportunity to feed in views to SCRG on areas for investigation. The terms of reference were substantially as proposed already:

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<sup>15</sup> See paragraph 51 above.

- “1. To draft statements of the principles/standards\* to be applied to ensure the Society's security objectives and internal controls are effective.
2. To identify areas where risk is perceived to exist\* and to review the management of that risk and its effectiveness against the standards set by the GMT.
3. To review the adequacy of security and control measures within systems (mechanised and manual) in accordance with the Operational Principles issued [on 26 August 1993] and to develop these Principles into documents capable of practical application.
4. To review the Society's (and subsidiaries') arrangements for deterring, for identifying and for handling fraud, whether internal or external.
5. To make recommendations to the GMT regarding the above.
6. To provide assistance for the GMT to make periodic reports to the Audit Committee on the levels of risk perceived and on the Society's and subsidiaries' management of these risks.

\*where not already defined or identified”

The initial tasks for the group were listed: (1) to make recommendations for principles/standards to apply on access, management control, and authorisation; (2) to summarise the SCRG review recommendations; and (3) consideration of SCRG's proposed future reviews.

72. The audit committee began to express an interest in becoming more involved in the area of risk at about this time. On 5 March 1996 Hirst wrote to Bowley commenting on a proposal by Alan Tritton on 1 March 1996 that an item be included on the agenda for the audit committee relating to risk management. The issue had been raised at the January 1996 board meeting. Hirst enclosed a lengthy paper in which he asserted that existing arrangements were comprehensive and well established and required little change. He mentioned the formation of the new SRCG and suggested that the terms of reference of the audit committee should be amended to include regular reporting by that group to the audit committee.

73. The proposed paper stated that Tritton's proposal was that, while the formation of a formally constituted board sub-committee - a risk management committee - might be inappropriate, the audit committee would be willing to consider the topic specifically at forthcoming meetings. The audit committee would take account of the detailed reports which had already been produced or which were planned, and consideration would be given to widening the terms of reference of the audit committee in an appropriate way. The paper contended that the Society had established various mechanisms, forming part of the internal control framework, to identify, monitor and manage business risks. The mechanisms were part of the framework described in the corporate governance statement in the 1995 report and accounts. Included in the list of topics covered, Hirst mentioned the monitoring of actuarial management reports. These considered, inter alia, solvency; the implications of revenue and solvency projections for investment policy; and the bonus declaration and policy considerations relating thereto. He referred to the proposals to widen the audit committee remit to include the review of the Society's statement on internal control (to be included in the report and accounts) prior to endorsement by the Board; and the receiving and monitoring of reports from both the external auditors and the SCRG. He outlined the purpose of the SCRG. This did not include actuarial management matters.

74. The rationale for the new SRCG was set out. There were principles of operation formulated to combat the risks that the GMT had decided were not acceptable. The relevant operational principles had been issued to assistant general managers and senior managers by Ranson on 26 August. He said it had become clear that a formal mechanism was needed to give comfort to the GMT and to the Board that the Society's security and risk management objectives had been and were being met and

that internal controls were effective. He drew attention specifically to one of the terms of reference requiring the group to provide assistance to the GMT to make periodic reports to the audit committee on the levels of risk perceived and the Society's and its subsidiaries' management of these risks. In the circumstances, no material changes were proposed to the Society's existing approach to identification, monitoring and management of risk other than to extend the terms of reference of the audit committee to include the following:

"To receive reports from the Security, Risks and Controls group on the levels of risk perceived and on the Society's and its subsidiaries management of those risks; and to receive reports on specific topics commissioned by the Committee or by the Board for consideration by the Committee."

75. The terms of reference of the new SRCG were set out at length, supporting a conclusion that a single group, which addressed all areas of the Society's operations, would assist the identification and investigation of potential security risks and enable concerns to be promptly addressed, and give SRCG (the existing review group) a formal route specifically to raise issues needing general management action. The assertion of management was that it was preferable that risk management should come through management and staff working within the "checks and balances that operate within the organisation", rather than through a committee's consideration of the detail. It was said that:

"... in general the understanding of risks and through it decisions as to their management or recommendations concerning this, where reserved for Board decision, is more likely of success when undertaken by management and staff in performance of their duties, within the checks and balances that operate within the organisation."

Detail would not address "the issue which would be key to the Board". The proposed statement concluded:

"The Society's approach to the management of the risks in the operation of its business is established, wide-ranging and comprehensive.

Existing procedures enable appropriate reporting to the Board in relation to operational and financial risks, although it is recommended that the Terms of Reference of the Audit Committee should be extended to enable it to review reports from the newly formed Security, Risks and Controls group."

76. On 25 March Tritton wrote to Bowley. He said that he had come to be increasingly of the view that, provided the Society had very tight internal operational controls, duly sanctioned limits for counter party or settlements risks, derivative exposures and so on, then the responsibility for the business risks incurred by the Society were properly the concern of the Board as a whole and not that of a committee. He saw no reason for a risk management committee per se. The risks referred to could and should be dealt with by the audit and investment committees. Bowley replied on 29 March. He agreed that, given the financial nature of the Society's business it was unlikely to be sensible to divorce risk assessments and controls from the Board and the existing committees.

77. Tritton's letter revealed no knowledge of Hirst's proposals, nor of the extent to which the new committee structure had proceeded. On 18 March 1996 the SRCG met. The minutes noted that the audit committee had been briefed about the group, but that item 6 of the group's terms of reference (to provide assistance to the GMT and to make periodic reports to the audit committee on risk and on the Society's and subsidiaries' management of risks) had not been included in the audit committee papers and should therefore be taken as an "in brackets" addition to the terms for the group's use only. The file copies of the terms of reference at the time similarly excluded item 6.

78. On 15 April Bowley reported that a paper on risks was being prepared for the next meeting of the audit committee. On 5 June there was a further internal memo

copied to senior management expressing concern on the scope of the remit of the SRCG. Following some debate, the minutes of the SRCG for 18 June 1996 recorded agreement among management on the way forward. They would prepare internal controls and related guidance, including details of a self assessment approach and instructions as to what managers needed to do; a paper on current office rules, initially relating to confidentiality, access and authorisation and any related guidance. The requirements for effective instructions were set out. SRCG was to review the self-assessment results as part of the process of being able to give reasonable assurance to general management and directors on internal controls. Forms for the self-assessment exercise were to be drafted. Detailed procedures were worked out. The analysis of risks continued.

79. Directors meantime continued to express interest in the management structure. On 13 June 1996, Peter Davis wrote to Bowley asking about the SRCG. He had identified areas that were within the scope of SRCG review but were regarded as falling outside the remit of the audit committee. He wanted to know the procedure for following up points which were outside the focus of the audit committee, so that the Board could be satisfied that there were no points that were accidentally omitted from follow-up procedure. He wanted a specific mechanism for the Board (or the audit committee) to have assurance in relation to compliance with DTI guidance notes, which the Board was required to certify in the DTI return, and wanted to know whether SRCG provided this. And he asked for a sight of any background papers on the establishment of the SRCG, and whether there were minutes of any decision not to have an internal audit function.

80. On 1 July 1996 Bowley wrote to Ranson enclosing his draft reply to Davis, explaining “why we do not have internal audit and how we set about controlling corporate risk”, and asking whether it might be shown to Tritton who had asked to see the reply in draft. There was extensive internal discussion. On 8 July Bowley circulated a document re-stating the ‘Office Principles of Operation’. The principles covered confidentiality; access to data and authority to initiate change; and requirements for authorisation of actions, with illustrative discussion of the principles in operation.

81. On 12 July Tritton wrote to Bowley approving the reply to Davis. He outlined his own views on risk. He identified the business risk incurred by the Society as properly the concern of the Board. He considered that the operational risk incurred by the Society in the furtherance of its business could legitimately be delegated to the audit committee, who needed to take a view as to the management and control of these operational risks. He commented that at the end of the day, the most important thing was for the Society not to get caught out by a major loss, which with the benefit of hindsight it should have foreseen and controlled.

82. Bowley sent a copy of Tritton’s letter to Ranson on 16 July, commenting that it gave a clue to Tritton’s views on risk. Bowley suggested that there was clearly some confusion in Tritton’s mind about the part management should play and the extent of monitoring. That would need to be addressed through “the ‘risk’ note” and discussion of it at the audit committee.

83. The SRCG met on 22 July, and agreed the form of papers to go to Ranson for scrutiny and agreement. The documents were sent to Ranson on 1 August 1996. The covering memo referred to the paper on risk management presented at the March 1996 audit committee meeting which gave the background to the formation of the SRCG, and to the audit committee’s discussion of the need to give directors reassurance as to the effectiveness of controls and any statement to be made in the report and accounts in relation to this. The documents were said to concentrate on: raising awareness of the topic and of managers’ responsibilities in relation to it; a statement of principles in selected areas; and information gathering from which assessments as to the effectiveness of controls could be undertaken. The means of gathering the information that was proposed was self-assessment by managers of the risk and controls in their area. Drafts were submitted of an internal

controls paper, with a hypothetical self-assessment exercise, and revised office principles of operation.

84. The documents were approved for distribution and were sent out with the SRCG minutes of 30 August. These included documents on internal controls, principles and related guidance. It was agreed to start trials of the self-assessment exercise. The aim was thereafter to finish the self-assessment exercise for the whole office by mid-December, so that a report could be made to the March audit committee. There was discussion of a note of corporate risks. Ranson considered it to be too detailed, and a "higher level" version had been drafted for further discussion. Revised payment authorisation rules were discussed and there were proposals for a simplified authorisation for 'system controlled' payments, with current arrangements continuing, subject to clarifying the position on streams of payment, ex-gratia payments and writing-off of debts. Thereafter there would be proposals and a draft Board paper to be considered by the SRCG. There were proposals for SRCG's future reviews. Topics for future meetings of the SRCG were noted, including deterring, identifying and handling fraud, and various principles of operation that needed to be developed, and corporate risks.

85. Hirst sent Bowley a further memo on 5 September relating to corporate governance. He referred to the proposal that had gone to the March 1996 audit committee that the statement in the 1995 accounts on governance should be extended to indicate that the Board reviewed the effectiveness of the system of internal control regularly and to set out the form of the internal control framework. He attached the draft statement as considered by the committee and the minutes of that meeting. He pointed out that the latter referred to removal of the control framework section of the statement on internal control; the fact that the subject should be taken before another meeting of the audit committee; and that, as noted by Ranson, the duties of the directors of insurance companies were relevant. He enclosed a "re-issue" of part of his paper on corporate governance dated 30 January 1996, which, he said, provided background information on the current position on the guidance to directors' on statements of internal financial control.

86. The development and refinement of the statements continued. On 17 September Bowley wrote again to Ranson. He commented that management was committed to preparing some sort of statement to the audit committee related to "the main risks faced by the Society and the actions being taken to avoid or reduce them", for consideration by the committee before submission to the Board. He noted that Ranson was still unhappy with Driscoll's second note of risks primarily because of his desire to ensure the Board focused on the risks inherent in strategic direction and delegated all other risks to management, monitored in only limited areas by the investment committee, audit committee and auditors.

87. Bowley also noted that Ranson had raised the duties of the directors in this context, and that he considered that they should not be involved in detailed management aspects of the business. He mentioned that management was concerned to ensure that the Society's disclosure in the report and accounts was reasonably up to date on the related subject of internal control. Top management, he suggested, needed to clarify how to handle the risk management topic and also the effectiveness of internal control with the audit committee and the Board. He referred to the approach adopted by other life offices and sent the material Hirst had recovered from other offices. Bowley appears to have tried to encourage a more sympathetic view. He said:

"The enclosed copies of section of the relevant paragraphs of some insurance companies' reports may be helpful. In all three cases the Audit committee is involved in reviewing management reports including risk, as well as internal controls (or internal financial control). I suspect the Scottish Widows' approach might appeal to you - the question is how to convince our Audit Committee that our management activities are sufficient which too high a level will not achieve."

At about this time, the draft annual report of the SCRG to the audit committee was circulated for review.

88. On 24 September Bowley wrote to Tritton, Davis and Martin. He referred to the history of the request for a brief statement of the main risks faced by the Society and the actions being taken to avoid or reduce them. He referred to the time and effort put into the exercise. He said that it had become increasingly evident, which perhaps they should have recognised at the audit committee meeting, that whatever was contained in such a statement could only ever be examples, whatever the level at which one pitched a statement of risks. This led to the conclusion that:

“This should not be taken as an inability to identify current risks, although inevitably risks must exist which are not identified. Rather it is the risks that present or may present themselves in the future that are relevant. Some can be speculated on but an unknown number must be that (i.e. unknown). If we accept that a statement can only ever be examples from an unknown population then we feel that such a statement would be severely limited in value.

Where this is leading to is that we have concluded, on reflection, that a statement which covers superficially specific risks would be inappropriate. Presentation of specifics is almost certain, we feel, to lead to concentration on consideration of those specifics (i.e. on the detail of individual risk areas and their management). It is that which we regard as inappropriate.”

89. Two reasons were advanced for this conclusion. First, risk had dependencies that might be variable. And the information necessary to understand risks across a wide range and in particular their dependencies and complexities could not be conveyed successfully to a committee, however constituted, and especially by what would by definition be a brief statement. Bowley advanced the view, on behalf of the executives, that

“... in general, the understanding of risks and through it decisions as to their management or recommendations concerning this, where reserved for Board decision, is more likely of success when undertaken by management and staff in performance of their duties, within the checks and balances that operate within the organisation.

Secondly, the consideration of the detail would, by its nature, add little or nothing by way of addressing the issue that should be key to the Board, which was the ability of the organisation to: anticipate risk whenever and wherever it might occur; assess the extent and likelihood of risk; where appropriate, avoid risk; where risk was not or could not be avoided, reduce, where appropriate the chances of it occurring; and where risk occurred, mitigate its affect. In these areas, management felt that the Board would wish to be reassured as to the processes relating to these matters and allied to that the quality and culture of the organisation. He said that the paper presented to the March audit committee had described the framework, a framework which should give an appropriate level of reassurance. The detail contained in the items within the framework provided opportunity for that reassurance to be reinforced.

90. The letter had presented management’s case for excluding the audit committee from risk assessment. The debate continued at the next audit committee meeting in October 1996. There was discussion of the fact that both the SCRG and the SRCG reported to management, not directly to the audit committee. This led to a discussion of the structure of the two groups and whether they ensured that the directors were able to keep effective internal control.<sup>16</sup>

91. Finally, on 7 November, there was wide circulation of a full series of papers. The covering letter from Bowley described the work of the SRCG “undertaken to date

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<sup>16</sup> Davis (understandably) found the names of the groups confusing. It was proposed that the newer group, the SRCG should be re-named the internal controls review group.

by the Group and approved by RHR". Appended were the terms of reference of the SRCG.

92. Relationships with the audit committee remained difficult, and Davis in particular continued to press his views. An internal memo by Bowley of a meeting with Davis recorded the latter's concerns. Davis did not accept the arguments put up in the September letter and wanted to readdress the absence of a risk note along the lines he had suggested. Bowley said he had outlined the role of management in terms of responsibility for internal analysis and control of risk; and the need to enable directors to be satisfied that this subject was under control, thereby enabling them to give the assurance as in the report and accounts. Davis had not accepted that that meant the audit committee members should not see a little way behind the curtain and get answers to reasonable questions such as the risk list and handling review he asked for. Bowley had suggested that he await issue of an explanatory note about the total structure covering Board and GMT responsibilities and the fit of the SRCG with the SCRG. Davis had agreed to do that, but proposed to raise his request for the risk data with Tritton as chairman of the audit committee. He saw the need for greater comfort and felt that the risk schedule would help. Bowley recorded that he thought that Davis might also express a wish to talk to the auditors about the general approach to this matter of control at the Society in order to be sure that they were satisfied. But Bowley had confirmed that Davis did not have a wish to move to any internal audit "formation" in the Society.

93. A draft of the note on roles was circulated to senior management for comment on 13 November. The covering memo from Driscoll explained management's view that the original requirement for the note resulted from uncertainty as to the respective roles of the SRCG and SCRG. But that was too narrow a perspective. The note should have a wider scope and in the process touch on the matter of Board and executive responsibility. Subject to other observations, the note would be submitted to Ranson for final agreement.

94. The contents and tone of the exchanges says much about executive attitudes. Consistent with those attitudes was the report of Bowley to the SCRG on 11 November:

"1. RQB reported that it is intended that the GMT should make an annual report to the Audit Committee (with help from the Security, Risks & Controls Group) rather than such a report to be from the Group itself."

95. The revised note was sent to audit committee members on 31 December. The covering letter from Bowley expressed the hope that the note, agreed by senior management, "will not only clarify the position but also move forward the support to directors in relation to ensuring effective internal control". In particular committee members would see from the note that future annual reports on internal control would be made by the general management team (GMT) to the audit committee and through that committee to the Board. At this stage in the proposals there appeared to have been some movement towards relaxing executive ownership of risk management.

96. The note recorded that the directors were ultimately responsible for establishing and monitoring that the Society had in place an appropriate system of internal controls. This was acknowledged publicly in the report and accounts. The objective of the audit committee, as stated in its terms of reference, was to assist the Board in this matter, among other things. The executive responsibility for "establishing and monitoring" rested with the GMT. It was incumbent on the GMT to satisfy the Board that the GMT had given proper discharge to their executive responsibility and for the Board to rely on this and such other information as they required or was available to them (e.g. the external auditors' management letter) with regard to discharge of their ultimate responsibility in relation to internal controls. In general it would be the case that the audit committee would act on behalf of the Board.

97. The re-naming of the SRCG as the 'Internal Controls Review Team' (ICRT) was noted. This arrangement complemented rather than replaced assistance provided by individual members of the Society's management. Whether through the ICRT or individual members of the Society's management, the GMT might empower those concerned to take actions on its behalf and require that the results of those actions were monitored. In this context, the note stated, it was clear that the matter of reporting to the audit committee had been somewhat misdirected. It was proposed that:

- i. The GMT report formally to the audit committee, at least annually, on internal controls. The purpose would be to assist in providing reassurance as to the effectiveness of the Society's system of internal control (i.e. satisfying the Board, via the audit committee, as to the proper discharge of the GMT's responsibility in this area). Unless specific features were worthy of comment this report would tend to provide reassurance as to the general effectiveness of the systems of internal control.
- ii. SRCG continued to submit an annual report to the audit committee, covering in summary form the reviews and their findings undertaken in the previous period. By its nature such a report provided reassurance as to the existence and effectiveness of internal controls in respect of particular parts and functions of the Society.

98. As at the end of 1996, therefore, the efforts of the audit committee to obtain an analysis of the risks confronting the Society appeared to have been frustrated. The GMT would not have full and formal reporting responsibilities to the audit committee on internal control. Reassurance on management's performance did not allow for full review or investigation.

99. Whatever other risks there might have been, had this been the end of the matter the result would have prevented the audit committee from having access to information about the product and other valuation risks confronting the Society, except insofar as they were reported on in the actuaries' reports to the Board. The annuity guarantee risk had not been reported to the audit committee, nor were the various valuation issues discussed above<sup>17</sup>. The Board could have revoked any existing delegation of powers to executive management, but had not taken such a step.

100. The renamed ICRT met on 20 January 1997, when the papers brought forward from 1996 were discussed further. In relation to reporting it was minuted that the audit committee had been told that the team existed to assist the GMT in the performance of management duties, and that the GMT would report annually to the audit committee in October.

101. At the first audit committee meeting for that year, on 12 March 1997, the committee were told that they would receive a report on internal controls in October. A member of the committee asked for, and was given, confirmation that if any major problem were clear to the GMT at any time, it would be brought to the Board's attention as it arose without awaiting the October report. It was also said that a more frequent interim report might be helpful. Meantime the self-assessment exercise continued.

102. No problems were reported at the June and July meetings of the audit committee. At the audit committee meeting of 8 October 1997 Driscoll presented the first annual report on internal control. He outlined the systems in operation directed towards providing reasonable reassurance with respect to: the business being operated efficiently and effectively; the safeguarding of assets against unauthorised use or disposition; the maintenance of proper records and the reliability of financial information used within the business or for publication; and compliance with laws

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<sup>17</sup> See chapter 6.

and regulations. He referred to comments by Ranson that the Society's "cohesive" approach to principles of operation differentiated it from many other organisations, and it itself acted as a control. He and Hirst commented on the self-assessment exercise. Directors asked for further information on the self-assessment exercise.

103. Of more central importance for present purposes, directors returned to the issue of a list of the main risks to which the Society was subject. The issue had been behind the papers submitted in March. Nash and Bowley agreed to "consider further what could usefully be provided". There was discussion whether a risk management function would be appropriate, in view of the potential for certain risks not to be addressed adequately. It was agreed that the issue would be considered. The directors had not been deterred from pursuing their interest in risk management. On 8 October there was a private meeting between the audit committee and the auditors, Ernst & Young. Arising from comments then and in subsequent discussions between Nash, Sclater and Tritton, arrangements were made for a further meeting with the auditors on 22 December to discuss risk.

104. The further development of risk management was discussed at the meeting of the ICRT on 21 November 1997. A package of materials on the self-assessment exercise and a risk list were to be issued to the audit committee after the planned meeting with the auditors. It was noted that the auditors had expressed some concern over the Society's somewhat fragmented approach to risk management and the possibility of "holes". Nash undertook to consider whether Davis should be invited to attend the meeting with the auditors. In relation to risk management generally, the team considered that it should be renamed the 'Risk Management Group' and have suitable revised terms of reference. The context remained as before: the body responsible for "risk management" was the GMT (i.e. the general managers only) with those principally responsible being Nash, Bowley and Driscoll. This marked a significant point in the development of risk management systems. The audit committee was to have the risk list that had been sought for some time. There was to be a full assessment of the issues with the auditors. And there was recognition that there might be deficiencies.

105. Ranson had retired in July. Hirst told the inquiry that it was his recollection that towards the back end of 1997 there was a lot of pressure from non-executive directors to implement change in relation to a number of matters, including risk and internal audit. In Hirst's view they saw the retirement of Ranson as presenting an opportunity to make changes. He said Ranson had been a strong character, a clever man, difficult to challenge. The meeting on 8 October with Ernst & Young gave the auditors an opportunity to make a presentation on risk. Davis attended the meeting. In preparation for the meeting Driscoll prepared a document analysing the existing system of risk management and controls.

106. Driscoll's document drew heavily on earlier statements. It identified five 'entities' as components of the system: the Board; the Executive; independent functions of a corporate nature; independent functions specific to particular operational activities; and line management. The Board was ultimately responsible for establishing and monitoring that the Society had in place an appropriate system of internal controls; and for identifying risks and ensuring that those risks were appropriately managed and controlled. Board committees, principally the Audit Committee and the Investment Committee assisted the Board in this matter. In general the responsibility for identifying, monitoring and controlling risks, and for establishing and monitoring controls had been delegated to the executive. It was incumbent on the executive to satisfy the Board that the executive had discharged their responsibility and for the Board to rely on this and such other information as they required or was available to them. The executive was concerned with setting policy and overseeing the control environment, on occasion through management groups. The ICRT had an overall business risk management responsibility and policy-setting role in respect of risk management (in particular those of a corporate nature) and controls. The SCRG was an example of an independent function of a corporate nature. Line management would establish when necessary, and operate,

controls to mitigate risks to their own part of the business, and to ensure quality of the end product.

107. The meeting on 22 December discussed risk management and internal audit widely. The auditors discussed and illustrated current trends. Davis stated that he believed that from a systems and product development perspective business risks were well understood and acknowledged. However, the Society was now a group and faced a diversity of risk. Ernst & Young expressed concern whether the Society was confident that all change programmes "added up" to meet the corporate strategy. Driscoll went over his paper on the Society's current framework for risk management and controls. Nash said that he believed the control framework to be reasonable and comprehensive albeit not of a standard format. He asked whether others had concerns about or perceived there to be "gaps" in the approach.

108. Ernst & Young noted a long-standing concern regarding the absence of traditional internal audit, in particular the absence of any formal checking function. Ranson's view had been that there was a need to trust management. Ranson had also claimed that the review group, SCRG, had a preventative role, but in the auditors' view that did not accord with practice. The skill set of SCRG might be deficient in various aspects, for example knowledge and understanding of fund management activities. Davis, however, was supportive of the executive on this point, stating that the Society had a developed risk management culture and, in particular, exercised strong business controls. The Society's approach to risk management was more than operational/preventative, although he was of the view that there was a need for some more traditional internal audit work (checking) to be undertaken.

109. Davis said that his long-standing worries regarding the Society's approach to risk management related to:

- i. a concern that the Board was being prevented from understanding what risks the business faced and how those risks were managed and controlled.
- ii. a lack of clarity about responsibility for risk management and the reporting in relation thereto.

He expressed the view that the Society would move rapidly in the right direction if (ii) could be improved. He thought that the Society should continue to operate on the basis that line management had a key role to play in establishing and operating controls to mitigate risks. But he was concerned whether line management understood the business risks in the functions for which they had responsibility.

110. Ernst & Young noted that solvency management was always going to be a central concern for the Society, given the policy of full distribution, and questioned whether investment managers did really understand that risk and the impact that their actions could have. Davis said that there was a need for the Society to develop a policy statement on business risk management and control and for that statement to be promulgated to and implemented by all companies in the Group. A single document would help to focus the attention of the Board and all in positions of responsibility within the business. Bowley agreed with this view.

111. On 23 December Bowley briefed the ICRT on the meeting with the auditors. He reported that the main conclusions of the meeting were that the Society should review its "hands off" approach to subsidiaries and take a more active role in respect of the investment area. The record of the ICRT meeting does not disclose Davis's concerns regarding the Board being prevented from understanding what risks the business faced, nor Ernst & Young's concerns that the Society should revise its approach to risk management generally. The minutes recorded that the risk list was to be sent to the audit committee with an 'overview' document and a note of action being taken to deal with hostile takeovers, fraud, subsidiaries, and overseas operations.

112. On 14 January 1998 Davis sent Tritton a copy of his notes of the meeting with the auditors. Tritton replied on 19 January. He rehearsed the steps that had been taken to deal with risk, mentioning the audit committee, the SCRG, the ICRT and the regular reporting structures. He was not convinced that there was a case for another risk management committee. Significantly, he repeated his usual concern:

“There are many concerns and worries which we have in managing the Equitable business but these pale into insignificance compared with our solvency and free asset ratio risks and the extent of our guarantee liabilities. These are very much a Board responsibility and indeed are regularly brought to the attention of the Board.”

At that stage the annuity guarantee problem had not been discussed with the Board or the audit committee: Tritton’s concern was with the solvency position as reported by the actuaries.

113. The risk list, initially requested by the audit committee in March 1996, and the overview prepared by Driscoll, were distributed by Nash to the audit committee on 29 January 1998. The list was not new, it had been prepared in June 1996. It contained broadly the same heads of risk, although differing in detail, as the overview statement. Nash’s letter observed that a brief statement of risks could only ever contain examples and could not indicate all risk dependencies. He identified a range of risks to which particular attention was being paid in January 1998, which were the same issues referred to in the ICRT minutes: hostile takeovers, fraud, subsidiaries, and overseas operations. He told the audit committee that the role of the ICRT had been extended and enhanced, and that it had been renamed (again) as the Risk Management Group (RMG) to give a clearer picture of its remit.

114. Driscoll’s overview described the categorisation of risks adopted:

- i. Risks relating to the continued existence of the Society as a business.
- ii. Risks relating to the provision of the service by the Society to its policyholders.
- iii. Risks relating to the monies invested by policyholders and the returns on such monies.

He warned that the categories did not exist independently, but interacted upon each other. The list did not, other than in very broad terms, attempt to assess the probability of the risks crystallising adversely or of the impact should that happen. It did not offer a view as to the effectiveness of the actions identified either in theory or in practice. However, subject to all of the qualifications expressed, the audit committee had been provided for the first time with an assessment of the risks identified by management<sup>18</sup>. Against the background of developments at the end of 1997, it appears that the newly established risk management group was an innovative step for the Society in the direction of integrated risk management of a kind that had not existed previously, with a reporting line that would ensure a flow of information to the Board through the audit committee in the fullness of time. But the developments were late in time as events were to prove.

115. All three members of the audit committee responded to Nash’s letter. Martin observed on 30 January 1998 that he supposed that the Society’s biggest real risks, as contrasted with nightmares, were regulatory and computers, which, as expected, were well covered. He suggested disaster scenario testing: thinking the unthinkable. Tritton wrote on 13 February 1998. His view was that all business was a risk activity and that the proper recognition of the risks inherent in business, and the management and balancing of those risks were of paramount importance. In the light of the list, he was satisfied that there was a proper recognition of the risks undertaken by the Society and that the necessary control mechanisms were in place

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<sup>18</sup> It is of note that at this stage, in January 1998, the risk list dealt with guarantees in broad and general terms. There was no reference to annuity guarantees as a particular issue.

for the management of these risks. He expressed his reservations about solvency margins:

“I have, however, one caveat and this may or not be a personal view, I do not know. However, it is my belief that the Equitable as a mutual is managed too close to the margin. Now I know and I understand and appreciate all the reasons why this should be the case and philosophically do not disagree with the tenets of full, fair and equitable distribution of annual surpluses. However, I do believe that there is an increasing risk to the independence of the Society from this annual desire to distribute to the limit.

I also observe rightly or wrongly that the effect of such a distribution-policy is beginning to tighten our position. If it is not, why are we going down the subordinated loan stock route, why are we taking in more and more from future profits and so on. It may be that this all results from greater proportion of fixed interest stocks in our investment portfolio compared with other houses - I really do not know. All I know is that I am beginning to feel uncomfortable with the business being run so close to the margin and that this could well be the greatest risk we are running.”

He had consistently raised the issue over a period of time: the risk list clearly failed to focus the issue to his satisfaction.

116. Davis wrote to Nash on 9 March. He described the statement of risks as an excellent piece of work; more or less exactly what he had had in mind when he requested one. He commented that it covered the ground comprehensively, and offered some minor comments. He also raised the issue of contingency or disaster planning. He welcomed the further development of the remit of the risk management group, but still sought greater clarity and documentation of the group's policies and objectives.

117. Nash replied to Martin's letter on 5 February. He dealt with hardware risks, and went on to discuss the risk of failure to meet regulatory requirements, an idea that filled everyone with concern. He said that management would consider whether a practical test could be set in to the programme at some stage. He commented that there would be little time for discussion of the statement of risks at the March audit committee meeting.

118. Nash replied to Tritton at length on 23 February 1998. The reply was an important re-statement of the Society's position in relation to solvency and distribution, and it presented a direct challenge to Tritton on policy. It also indicated the extent to which the Society had lost flexibility as a result of the policies and practices it had applied in the past. Nash wrote:

“Thank you for your letter of 13 February 1998. ...

The first point I would make is that I do not believe that it is the annual distribution of surplus as declared bonus which is a major contribution to the 'tightening of margins' you describe. Since the late 1980s we have managed down the level of declared bonuses in line with falling yields, probably more aggressively than most other offices. In terms of the level of guaranteed returns we pass on through the declared bonus system we are below average.

The 'full distribution' philosophy applies to total policy proceeds and is most pertinent to the determination of final bonuses. There we could retain earnings from maturing policies to build up genuinely 'free' assets. However, total final bonus payments last year were £390m. If we had retained, say, 10% of that, that would only have contributed £39m to free assets. If we had done that consistently over, say, the last 10 years we might have built up around £¼bn of 'free' assets but that would still only be 0.3 of the minimum solvency margin. Building up sufficient free assets to have a material effect on the solvency position would give us a different problem - namely what, equitably, should be done with those free assets.

It is unarguable that the valuation regulations are more stringent in a low interest rate climate, that the 1994 regulatory changes reduced the room for manoeuvre and that the removal of dividend tax credits has led to higher reserves on pension business. I think it is important, however, not to get the position out of perspective. The ratio of available assets to the minimum solvency margin was 2.4 at 31 December 1992. Despite the factors described above and the rapid growth in business over the last 5 years, the ratio at 31 December 1997 is still 2.4 (and might creep up to 2.5 when all the figures are finalised). That does not seem, to me, evidence of a significant deterioration. We need to be careful that the greater focus we are now giving to our solvency position (which I regard as entirely appropriate) does not lead us to worry unduly.

As has been said on previous occasions, managing a with-profits office is all about striking a balance between conflicting factors. If the Board wants a significant improvement in the margin of solvency the following courses of action are open to it:

- (i) Give a much greater emphasis to fixed interest stocks in the asset mix - that carries the risk of significant underperformance of our policies relative to the market.
- (ii) Change the distribution policy to retain a significant proportion of earnings from maturing policies - as noted above, that will take some time to be effective. Meanwhile the competitiveness of our products would be significantly weakened and a central plank of the philosophy which characterises the Society would be destroyed.
- (iii) Reduce new business levels significantly - that will lead to a short-term reduction in cost-effectiveness, carries the risk of not being able to 'restart' new business at some future point and increases vulnerability to a predator.
- (iv) Reduce significantly, or eliminate, declared bonuses - the risks associated with such a course were discussed at the January Board.

All the above options carry significant risks of wrecking the business. Those risks need to be balanced against the risks you describe. There is no risk free option.

Whilst maintaining the current general approach there are, of course, incremental things that can be done. My management colleagues and I are addressing those. We have recommended, and implemented, a cut in declared bonus rates this year. The popular managed pension contract is being relaunched in a form which makes significantly lower capital demands. A number of other initiatives are in progress and my colleagues are mindful of the need to be vigilant to other possibilities. Over time these things will all help but I should be very concerned at the thought of a much more dramatic change of direction, of the types described above.

I hope these initial thoughts are of interest. Perhaps we could have a word at a convenient point as to how best to take this forward."

119. The audit committee met on 11 March. It was minuted:

- "8. Risk Management. Consideration of brief reports on
- the Society's approach to the management of risk
  - the main risks faced by the Society

The General Manager - Systems and Controls, David Driscoll (DCD), introduced the reports and commented that they were intended to provide an appreciation of the control framework which operated within the Society and the interaction of the various entities of which the framework comprised.

The Chairman of the Audit Committee, Alan Tritton (AGT), referred to correspondence he had had with the Managing Director and Actuary, Alan Nash (AN), regarding risks and their management. AGT commented that he was satisfied the Society recognised and controlled risks appropriately. AN commented that he considered the Society's control of risks had improved, both conceptually and operationally, and that the role of the Audit Committee and the other structures in place had significantly assisted in this.

There was discussion of the section of the report entitled "Risks and their management" and of the list of risks within that. It was agreed that 'reputational risk' should be included as a separate item in that list. It was agreed that the list of risks should be considered by the Audit Committee once a year, as part of the Risk Management Group's report to the Committee."

120. Tritton's concerns appeared to have been dealt with. He told the inquiry that his concerns about the changing financial position of the Society were instinctive rather than reflective of views formed on information he had had and figures he had seen. His letter to Nash reflected a feeling that the management was running the business too close to the margin. He interpreted Nash's reply as an indication that the directors should not worry unduly about the solvency position. His impression was that the ratios of available assets to the minimum solvency margins were not evidence of a significant deterioration in the Society's financial position. Tritton did not pursue the issue of the Society's thin solvency margin because he was concerned as a non-executive director that by trying to force through the options Nash had set out, he would be accused by the Executive of wrecking the business. Tritton told the inquiry, however, that as 1998 progressed the Board, and in particular the non-executive directors, did become progressively more concerned about the solvency margin. But it has to be noted that the annuity guarantee issue and mis-selling were changing the context at that time. In relation to risk management generally, Tritton considered that there was a carefully constructed edifice and he took the view that it was as watertight the Board could make it: no major risk would remain unidentified.

121. The developments at the end of 1997 and beginning of 1998 appear to have taken place without reference to the actuarial department. On 6 March 1998 Headdon wrote to Bowley referring to a number of the risks identified in the risks list that he as appointed actuary had significant responsibilities for, and some for which he had has a direct statutory and professional duty to manage. He said:

"I must admit that I find it odd that RMG felt able to report to the Audit Committee on the management of those risks without any reference whatsoever to me. If RMG is now going to include a number of actuarial management risks within its remit I feel strongly that I need to be involved."

The risks listed by Headdon as concerning him were typical actuarial areas: inability to meet technical solvency requirements over liabilities; inadequate capital base; mismatch of investment returns with bonus distribution requirements; mismatching of nature of assets and liabilities (type and term); premium rates are set too high (adverse marketing implications) or too low (not viable); adverse mortality experience; premium discontinuance/reduction under variable premium contracts; valuation of assets and liabilities; and policies that contain guarantees or conditions which become onerous.

122. There is a hint of change in the balance of power within the executive. Bowley was surprised by Headdon's concern. He wrote to reassure him that if the time came for his area to be examined, it would be done by self-assessment, with the results examined by the risk management group in consultation with him. He explained that the entries in the risk list sent to the audit committee contained statements of the steps known to be taken in risk mitigation and expressed that view that they should not be contentious. But he agreed that the remit of the RMG had been broadened and that practical review of specific risk areas would as a result be likely to involve various areas of the Society's activities in future. The new risk

assessment exercise would give Headdon an opportunity to record and review with the RMG the specific risk areas for which he and his staff were responsible. Headdon's involvement would be required as the RMG came to study his areas of interest.

123. Tritton returned to the issue of risk management in about September 1998 in the context of the annuity guarantees that had by then emerged. Bowley wrote to him on 30 September. Tritton had asked how the difficulties over the guarantees fitted with the risk management approach adopted to date. Bowley outlined the progress over 1998 in developing risk analysis. He failed to meet the challenge implicit in the question, and offered no answer to the question how the annuity guarantee problem had escaped disclosure by the risk management process that had been developed by management.

124. Bowley discussed the general approach: management had developed many areas of risk management and controls to be exercised in practice, with self-assessment exercises having helped to raise risk profiles among managers and staff. He pointed out that the risks associated with guarantees had been included in the list of risks. He said:

“As you know, the potential effect of guaranteed annuity options in conditions of falling interest rates was recognised some years ago and action taken to inform relevant clients by way of bonus notices. What was apparently not adequately handled was the way in which that was done (by reference to cutting final bonus to pay for the cost of the guarantees) and our not recognising the PR implications of that approach.”

But he assured Tritton that a wide-ranging review was underway on all guarantees offered by the Society and the relevant actions that needed to be addressed to avoid potential problems in future. The reference to Tritton's assumed knowledge, typical of communications between the executive and the Board, was no accurate. As discussed earlier, I have found nothing to indicate that directors generally would have known the background facts relating to the annuity guarantee issue, and the implications of the embryonic policies developed in the early 1980s.

125. In September 1998 management had in hand an assessment of the risk management system, and how it related to best practice, and were planning to engage external consultants. Ernst & Young were commissioned. There were external factors requiring amendment of practices. The audit committee was told of the current position and proposals on 28 October 1998 in the annual report of the RMG on the handling of risks and internal controls. Bowley referred to the principles of operation which had been issued and the further self-assessments which had been completed by managers. He also commented on the review of the risk management capabilities of the Society to be undertaken by Ernst & Young. Tritton commented on the fact that the guaranteed annuity rates issue had not been explicitly identified in the list of potential risks prepared by management. It was reported, as Bowley had earlier commented in his letter to Tritton on 30 September, but apparently without further comment, that the list had referred to guarantees under policies. Ernst & Young set out the scope of the review that had been instructed on 3 November 1998. Nash was involved in the review process. He had met with Ernst & Young “several times” in the autumn of 1998 to discuss risk management.

126. Implementation of the proposals followed. On 4 November 1998 those whom it was intended should be interviewed were informed. Other executives were told of the exercise on 6 November. Ernst & Young's interview process elicited widely varying views of the effectiveness of the SCRG, although the work of the group was generally seen to be positive. The annual self-assessment process was generally viewed as an effective tool for generating risk management discipline throughout the organisation. There were some concern about the group's focus and approach. It was thought by some to look at individual technical issues rather than the business as a whole.

127. The accountants were more critical: they identified a number of problems. The terms of reference of the SCRG did not extend to a risk management role. Rather, it performed a monitoring role, pointing out to the RMG those systems and control procedures that appeared inadequate. The SCRG focused only on operational risks, not strategic or corporate-level risks. The group was relied on by the RMG as its main source of risk identification, and drew on the annual self-appraisal exercise in that connection. But much of the SCRG focus was on the completeness of returns rather than the adequacy of the risk management methodologies/controls being deployed. The self-assessment process only took a "snapshot" view of risk at a point in time - it was static rather than dynamic. SCRG was thought to have limited involvement with business planning. New product development work or business opportunities were evaluated by various steering groups around the organisation. The group's views were not sufficient authority for implementation of recommendations. Overall they considered that there was limited scope for the SCRG and therefore the RMG proactively to identify potential or emerging risks.

128. On 11 February 1999, Hirst wrote to Nash narrating the recent history of risk management within the Society, summarising the views of Ernst & Young, and proposing an approach for the future. He concluded that the Society's approach to risk management had developed in a somewhat piecemeal fashion over the period since early 1993. The audit committee, Ernst & Young and management had all expressed concern regarding the Society's ability to provide the required comfort to the Board that management of risk (strategic and operational) was adequate.

129. Hirst made observations on the origins of the then current position:

“Our current approach to risk management has its origins in:

- the desire of management to ensure the proper operation of and where appropriate to improve, the Society's control framework. Thus, for example, in August 1993 RHR's published guidance to managers in relation to Operational Principles and, subsequently, what to do in the event of fraud; and SCRG was formed to ensure that office principles and internal procedures were being correctly applied and to assist managers at all levels by pointing out inadequacies, assessing risk and recommending possible courses of action. [Arguably SCRG was formed to placate certain members of the Board who were of the view that the Society should have an internal audit function].
- the Audit Committee seeking comfort that it was appropriate for the Board to express an opinion on [the effectiveness of] the Society's system of internal control. As the role and confidence of the Audit Committee developed it also began, with some encouragement from EY, to question the scope and terms of reference of SCRG, noting that it did not fulfil the role of an internal audit department; and to ask for the views of management as to the risks faced by the Society [the, so called, "risk list"].”

He also noted that:

“Our approach to risk management to date has been piecemeal. Indeed, in RHR's time it became the "art of the possible".”

The impression that one might have gained independently that internal control was developed as a rear-guard action at this stage against Board pressure for internal audit is supported by Hirst's assessment of this period. It is plain that Ernst & Young had supported the directors. The “art of the possible” had not allowed for the elaborations and implementation of a sufficiently robust system of risk management and review to uncover material risks in the actuarial area, and in particular the annuity guarantee risks that were then of central importance to the Board.

130. Ernst & Young proposed a wide-ranging revision of current practice. In his memorandum to Nash, Hirst summarised their views as follows:

“In summary, EY do not believe our approach to risk management is sufficiently robust:

- its focus is neither strategic nor operational.
- It is not driven down from clear business objectives (a reiteration of the point they made in December 1997).
- there is no concept of the risk pyramid.
- the "risk list" is not necessarily comprehensive and risks have not been prioritised and mapped on to the risk pyramid.
- our risk management function is under resourced.
- risk awareness and management does not cascade down through the organisation and remains primarily at the GM and AGM level.
- membership of the Risk Management Group does not cover all Group activities.”

With some minor exceptions (mainly relating to staff training and appraisal), he supported Ernst & Young’s findings and recommendations. He proposed taking further advice, appointing a risk management manager, and development of a comprehensive and effective risk management system. In the light of the annuity guarantee problems, the audit committee would accept nothing less.

131. In my view it is clear that the emergence of the annuity guarantee issue provided the audit committee and the Board with the opportunity to confront the serious limitations on the Board’s control over the management of Equitable. It was no longer possible for management to fall back on the plea that the Board should trust management as a substitute for a properly developed system of risk identification and assessment. But the deficiencies were not novel: what was new was a degree of acceptance of the need to deal with them.

132. The position was reported to the audit committee on 9 March 1999, when the intention to appoint a risk management manager was intimated and further reports were promised. Included in these was a re-formulation of the terms of reference of the audit committee including a specific reference to risk management. The meeting was the last attended by Tritton as chairman. Following the meeting, Davis wrote to Roger Bowley on 18 March 1999 asking to see a copy of the Ernst and Young report, commenting that he had ‘nothing sinister in mind.’ On 22 and 23 March Bowley wrote to Hirst and Nash enclosing a draft reply to Davis for comment. Each reflected management’s continuing emphasis on preserving aspects of the pre-existing approach. Nash in particular was sensitive to the need to avoid provoking the Board to a response based on the GAR issue. Bowley replied to Davis on 23 March 1999, commenting, inter alia:

“Risk Management Capability

Thank you for your letter of 18 March 1999. A copy of the E&Y report on this subject is enclosed, as requested. ...

We do however see a need to be sensitive to the fact that we have various strengths and a corporate culture at The Equitable based on a centralised, and in some cases unconventional, approach and that it may not be in our members' interests to change to too great an extent and too rapidly.

The E&Y report makes the recommendation that our approach to the management of risk should have a focus based on the Society's business objectives. In that context, we see the current “risk list” as a helpful starting point in the process of analysing, prioritising, and assessing risks and related controls at the strategic level. For the reasons touched on above, careful consideration will need to be given to any changes we make in the approach to risk at the operational level...”

133. Davis showed Bowley his proposed reply in draft, and it was an amended response that was sent on 6 April. He summarised Ernst & Young's findings and recommendations, identifying some criticisms of the methodology. More particularly, he made comments of his own. In relation to the 'Equitable culture', he was supportive of management, but observed:

"We must, nevertheless, recognise the heightened potential for loss, fraud and criticism in the present increasingly competitive environment. Indeed, our very uniqueness of approach makes it more than usually necessary that we not only manage the risks properly inherent in running the business, but also can demonstrate that we are doing so. In the current climate, our policyholders would, I believe, want us to rely on the trust culture only so far as we can demonstrate this to be reasonable, and within a control framework which reflects that we are doing so. I am not suggesting that we should adopt a classic internal audit approach, but that, in deciding not to, we have to be particularly attentive to the rigour of the processes, accountability, documentation and reporting in the framework which takes its place and provides alternative assurance.

We have, generally successfully, made line management responsible for compliance matters, with limited central interference and monitoring. It seems clear from the E&Y report that there is some way to go before we can be confident that we have successfully achieved the same for risk management.

...

Risk management is... inherently more difficult to control, record and monitor. Making it a line responsibility can be successful only if we have clear accountability and process, as well as reporting, monitoring and occasional testing of the system."

134. Bowley forwarded the letter to most of the executive members on 8 April 1999 with a note in which, inter alia, he commented that Davis' letter was particularly helpful in pointing up the difference between compliance and risk management and saying: "we would do well to note his conclusions arising from that."

135. The substantive proposals for reform were discussed on 15 June 1999. The committee were in favour of the appointment of a business risk manager. The chairman of the audit committee, now Peter Sedgwick, suggested that there should be an external appointment to head the proposed modern version of 'Internal Audit', which the committee supported. Part of the review and re-launch was likely to include revising the SCRG function. Hirst introduced a discussion of the Turnbull report. He commented on the key implications of the guidance for the Society and the Equitable Group. These included the need to adopt a flexible, risk-based approach to internal control, with a strong risk-management and internal audit capability to support management and the Board. The reviews and actions proposed were said to take account of the report. There was discussion of the guidance and on the need for risk management and internal audit arrangements to cover the whole of the Equitable Group.

136. Meantime discussions continued between Ernst & Young and management. In connection with these discussions with the accountants, Hirst wrote to Nash and Bowley on 14 April setting out a series of questions discussed the day before and what he understood to be Nash's answers. For present purposes it is necessary to note one only. In response to the question whether there should be "no-go" areas - that is functions (such as investments or actuarial) or companies (such as Permanent or ESC) which should fall outside the remit of the central risk management function - Hirst records that Nash's answer was that there should be no "no-go" areas. It appears that that was too general a statement. While operational risks within actuarial functions, e.g. loss of key staff, were considered and reported to Hirst, he told the inquiry that as matters developed:

“... there was no internal audit review of the actuarial function or the process for determining actuarial liabilities (Had the internal audit function been in existence for longer, some of the systems and procedures in the actuarial areas might well have been appropriate. But internal audit was only formed in May 2000).”

137. Hirst was appointed the manager of risk. He reported to Nash, but had a direct line of access to the president in relation to risk management. Mike Davis, the head of internal audit who had been externally recruited, had a direct line of access to Sedgwick as the chairman of the audit committee. The audit committee approved the appointment of Hirst as the business risk manager at its meeting in October 1999. The committee was told the SCRG would be disbanded to make way for the new business risk department and the internal audit function. The revised terms of reference of the audit committee were put forward at the committee’s meeting of February 2000. Equitable had finally a fully developed system of risk management and internal audit. Alas much water had already passed beneath the bridge and the House of Lords decision in *Hyman* was just five months away.

### **The Audit Committee’s Role**

138. The principal responsibility of the audit committee over the first few years of its existence was reviewing the report and accounts, with particular regard to:

- i. any changes in accounting policies and practices;
- ii. major judgmental areas and significant adjustments resulting from the audit;
- iii. the going concern assumption compliance with accounting standards.

Compliance with legal requirements, which had been among its initial interests, was not effectively dealt with until 1996 when the compliance officer began reporting to the committee.

139. The financial information given to the committee reflected this view of its role: the members were provided with the statutory accounts and returns, otherwise no financial information was given. According to Hirst’s statement to the inquiry, the executive’s view was that the numbers in the statutory accounts should not have been a surprise to the committee. The directors would have received monthly reporting packs throughout the year as members of the Board. The only significant changes from the reporting pack would have related to the valuation of investments, finalisation of the tax position and the movements in the technical provisions, including the impact of the bonus declaration. By the end of the first week in March positions in relation to the accounts were known and understood. Hirst would then prepare a paper which presented the report and accounts to the committee. The committee would go through the detail in the accounts and the notes on the accounts. And they would look at disclosures on governance and generally at the wording of the report and accounts booklets. Their interests were as set out in their remit. In general the committee pursued those interests. It is not appropriate to summarise all of the work of the committee. Some examples will serve to illustrate the work done.

140. The committee had an interest in changes in accounting policies and practices. On 14 March 1994 - the first meeting of the audit committee - Tritton questioned the fact that the accounts did not disclose movements on reserves. The period between 1990 and 1993 had seen material changes in the actuarial assumptions underlying the liability valuation, and this was known to Board members. In explaining the way in which life funds were permitted to report, the auditors and Hirst explained the past background relating to the advantages of non-reporting of short-term movements and indicated that there would be a new format of accounts in 1995 when the analysis would include greater detail about liabilities, unit-linked liabilities and any unallocated reserves. The requirement for true and

fair financial statements for life insurance companies was seen as a major change. In March 1995 Ranson told the audit committee of the responsibility for the directors to ensure and the auditors to give an opinion that the accounts are “true and fair”. He characterised this as “a first for the life industry”. The committee clearly understood that material change was taking place in reporting.

141. But there were limitations on what it was thought the committee could do. At the committee meeting in October 1996 one of the items on the agenda was proposed changes to the format and content of the Society’s accounts. Hirst outlined three areas of possible change to the accounts. In discussion, a committee member referred to the need to have regard not only to the responsibilities of the audit committee on behalf of the Board, but also the duties imposed by the Companies Acts and by the Cadbury Code which the Society accepted. He was told that it was not the role of the committee to undertake detailed work and reviews, rather to seek satisfaction that it could rely on management’s findings and recommendations.

142. On 8 October 1997 at a meeting of the audit committee, Hirst commented on a  
“... number of changes to disclosures to be made reflecting both the development of the business and changes to generally accepted UK accounting practice. In particular, reference was made to the manner in which Financial Reporting Standard 4 required us to account for the subordinated debt.”

143. The minutes of the audit committee show diligence in examining the areas of the Society’s financial statements that were considered to be within its remit, with one major exception: there was limited consideration of the valuation of liabilities. Until 1996 the regulatory returns were not within the scope of the committee’s remit. But the statutory accounts were, and the liabilities were the most significant item in the balance sheet in what was referred to as the “judgmental” area.

144. As noted above, “major judgmental areas” were within the scope of the audit committee’s remit from the beginning. It was identified in the January 1994 draft remit prepared by Ranson. But, until 1996, the committee’s responsibility for ‘major judgmental areas’ was constricted to the context of the reports and accounts. Excluded from its remit were, for example, the actuarial valuation of liabilities, both generally and in relation to the regulatory returns; areas relating to the regulatory returns generally such as solvency; the use and importance of future profits and other implicit items; assets valuation, and the identification and valuation of inadmissible items. Product development and the reserving implications of product guarantees were also not within the remit.

145. There is no record of any discussion of the regulatory returns by the audit committee minutes in 1994. In June 1995 there was a detailed explanation by Headdon on the importance of form 9, and some detailed discussions on future profits for the first time. The link between the DTI returns and the statutory accounts was explored. It appears from the record that the committee asked questions about the process involved, and that Ranson or Headdon gave explanations. There is no evidence of challenge of the solvency margin, nor of the decision to use of future profits as a means of supporting solvency. One has the impression of a process of education of the committee members in respect of the mechanics of the regulatory returns and the decisions that had been made. Typical of the references was the minute:

“A question about the purpose and use of the returns to the DTI led to explanations concerning the search for trends and the alerting of the DTI to any excessive level of guarantees or too rapid an expansion. The mechanics for questioning offices on their returns was outlined by Roy Ranson”.

146. At the June 1995 meeting, Martin asked how the directors were, in reality, to sign the certificates required of them for regulatory purposes in a secure way. The committee was advised that comfort could be gained from:

- i. the auditors' involvement which involved their giving the opinions that the statutory accounts were 'true and fair' subject to certain conditions and that the directors' certificate had been properly prepared in accordance with the relevant regulations and was reasonably made;
- ii. the professional and regulatory requirements laid on the appointed actuary; and,
- iii. the recognition of allowable delegation under company law to those properly qualified.

In relation to schedule 4, the valuation report by the appointed actuary, it was pointed out that the schedule was the personal responsibility of the appointed actuary. However, the 'true and fair' assessment by the auditors had for the first time brought in an element of independent checking of the appointed actuary's report and input. These assurances appear to have satisfied the committee.

147. In 1996 the remit of the committee was extended to include the regulatory returns. Thereafter, major issues relating to the regulatory position did arise, but the committee's role remained limited. The committee was not asked for its opinion on issues arising, such as the Society's solvency margin, or the use of future profits. From the minutes it appears that the committee asked relevant questions. The responses from Ranson and Headdon provided explanations of the processes involved, rather than justification of the decisions made in those respects. I have found it instructive to consider the approach adopted to the discussion of these in 1995 and 1996. The actuarial valuation of the liabilities of the office, the use of implicit items for future profits and zillmerisation, and the use of subordinated debt were all areas of potential interest in the case of Equitable, and could have provided focal points for the audit committee's examination of liability valuation over critical periods of the Society's history.

148. In March 1996, the committee concentrated on the report and accounts. The regulatory returns were discussed at the meeting on 12 June 1996. Headdon provided a commentary on the returns that set out a considerable amount of detailed information on selected items. Form 9 was described in some detail. He brought out the net assets position of the Society on the regulatory basis and discussed solvency and the use of the implicit profit items. He discussed the use of derivatives and their treatment in the returns. He discussed the revenue returns and the claims reflected in the appropriate form. He explained, in relation to valuation:

"The importance of form 45 showing the income yield on various asset types was stressed. It was noted that these yields govern the discount rates used for valuation of liabilities and that the overall figure of 5.15% was probably slightly higher than that of some other companies due to the higher proportion of gilts held by the Society."

However, in relation to schedule 4, the appointed actuary's report on the liability valuation, he reported, consistently with the comments made in 1995:

"This whole schedule setting out in much detail a report on the valuation was noted to be the responsibility of the Actuary of the Society, not that of the Directors."

This was to be a theme of reporting that was apparently accepted by the committee. Although the audit committee was not given the opportunity or information they would have needed properly to assess the judgments reflected in schedule 4, its members were told that it contained statements related to the business and valuation results. At the material time the appointed actuary had responsibility for the content and accuracy of schedule 4 of the return in a question with regulatory authorities, and a wider responsibility to his profession. But the fact that he had a professional and statutory responsibility for the schedule did not exclude the material it contained from the legitimate interest of the audit committee, nor his

responsibility for that material to his employers. In this, as in other areas, the actuary's external duties were conflated into an exclusive 'ownership' of the document and the information it contained, despite the directors' general responsibility for the financial affairs of the Society. and their obligations under the regulations to complete the required certificates. It is not clear on what basis the appointed actuary's duties to the regulator affected his duty to the Board and its committee to explain the basis on which the liabilities had been valued, from which he calculated the surplus available for distribution.

149. A similarly disjointed approach appeared in relation to investment. Ranson intervened in Driscoll's presentation to comment on the importance of the responsibilities of the audit committee being kept separate from the role and responsibilities of management, as he saw it. The chairman responded by expressing the importance of the extent of all kinds of risk being clear to the audit committee in accordance with its wide remit.

150. Headdon's presentation and Ranson's intervention illustrated an approach that had a common base: the executive of the Society acted on the basis that there were aspects of management that were outwith the scope of the audit committee's remit. In particular, this extended to the core valuation of the Society's long-term liabilities. The account of developing pressure from members of the committee for more information on risk reflected increasing discomfort. But at this stage in 1996 the management position was accepted by the committee. The position was the same in 1997. The committee was told that schedules 4 and 6 were the responsibility of the appointed actuary.

151. Tritton's general view was expressed by him in interview as follows::

"... There was at the top the Appointed Actuary and his team of actuaries. Then there were the executive directors, all of whom, bar one, were actuaries: then there was the Senior Risk Management Group consisting of senior executives; then there was the Chief Accountant and his Department; then there were the Auditors who had actuarial partners; then there were the Regulators, the Government Actuary Department. And then there were also the lawyers, Denton. None of these ever expressed to me as a non-executive Director any concern as to the financial condition of the Society until 1998 when the GAR problem arose."

Martin's view, when asked what his understanding was as to how the liabilities were valued, was similar. He did not consider it the audit committee's duty to look at the valuation of liabilities. This was rightly left to the experts:

"The Board properly regarded the valuation of liabilities as being within the sole ambit of the Appointed Actuary and his people. We had no actuarial expertise and could not be expected to have any. It was entirely his expertise...As I saw it, the non-executives were more responsible for assets than liabilities, but, of course, the whole board was responsible for the whole business but with experts having expert professional responsibilities we all respected."

152. Hirst's comments were to the same effect:

"Schedule 4 was considered to be the sole responsibility of the Appointed Actuary. There was no discussion of this in the Audit Committee meetings or at the Board meetings (when the statutory report went to the Board without being seen by the Audit Committee). The Audit Committee and the Board appeared to accept that Schedule 4 was the responsibility of the Appointed Actuary and did not appear to challenge either RHR [Roy Ranson] or CPH [Chris Headdon] on this matter..."

153. Bowley's comments to the inquiry suggested that the committee's interests in detail grew with time. . It was provided, in his view, with more information than in most offices. The executive made more effort to explain matters. He could not say

whether the non-executive members picked up the explanations. It is my impression from wider discussions that the executive may indeed have provided more information to the audit committee and the Board than was provided in other offices. But the non-executive directors would have been better served by less, and more focused information, adapted to ensuring that they were instructed on the issues arising in relation to the decisions they had to make.

154. The pattern of the committee's business in 1998 was similar to that in 1997. The returns to HM Treasury were presented. Headdon described the purpose of the returns as being:

“... to provide evidence of proper records being maintained by the company to enable the returns to be made, to provide data about the insurance industry and an indication of trends of a particular company compared with the industry. The Government Actuary's department also considered the returns and were principally concerned in ensuring that the companies were exercising prudent reserving.”

He reminded the committee that “responsibility for relevant parts of the returns remained with the Board”.

155. The returns had changed little from the previous year apart from two items: the subordinated debt and an explicit resilience reserve. Explanations were given. There was no record of discussion. Again schedule 4 was said to be the responsibility of the appointed actuary. The committee was taken through the notes, in particular those referring to the section 68 orders, allowing the Society to include a future profits item on its return, and allowing the Society to disregard its subordinated debt liability for the purposes of form 9 solvency. It is not recorded whether the prudence of the section 68 orders was discussed. There is no record of any questions whether the future profits item was based on reasonable assumptions, or how and when the Society intended to repay its subordinated loan. Tritton told the inquiry that he was concerned about the use of future profits, but he felt constrained from criticising this as it had been allowed by the regulators:

“My main concern however arose with regard to future profits. The regulators accepted this as presumably normal practice, but to me for the Society to need to take future profits on its business to bolster its solvency position, pointed to some weakness in that position. What would happen, if for any reason, future profits began to dry up? I did not accept this as sensible regulatory practice, but it was allowed and upper limit figures were set for this practice. However the Society kept its future profits figure some way below that allowed by the regulators, on the basis that full utilisation could have been construed as a sign of weakness.”

156. By 1999 the committee was deeply involved in discussions related to the annuity guarantee issue. The committee first discussed the guaranteed annuity rates on 24 February 1999 at a special meeting to discuss reserving and disclosure. Headdon put forward four different levels at which the additional liability arising from the GARs could be assessed. The levels were those already discussed, ranging from a commercial cost of £50m, to the level implied by the FSA guidance, which would amount to a liability of £1.8 billion. The derivation of the values was discussed. In 1999, the executive failed to present the statutory returns to the audit committee for review prior to the Board. This was said by Headdon to be “due to the early submission of the returns that year”.

157. The audit committee do not appear to have been asked to consider whether or not the GAR provisions were appropriate. They were, however, clearly told that Ernst & Young could agree with the reserve for the commercial cost, and for the Companies Act accounts. In relation to the latter, the committee were told that:

“... this amount was derived by assuming a £15% take up of guarantees on the main relevant classes of business. This was a prudent basis, considering that the current rate of take-up was between 1% and 1½ %.”

The committee were told further that “this did not impede the Board’s bonus decisions”. They were not asked to consider whether the Board’s bonus decisions remained appropriate; they were not given any information on which to base any such questions. They did, however, consider whether there would need to be disclosure in the report and accounts of a material contingent liability in respect of the GARs. The committee decided such disclosure was not necessary, based on the “strong legal opinion that the Society’s directors had acted entirely properly and within their powers in adopting the system of final bonus additions”.

158. It is not possible to tell the amount of time spent discussing and debating the GAR provisions, nor to tell whether the committee’s views were wholly prompted by the executive or not. The audit committee met again on 9 March 1999. The GAR reserving issue was raised once more, but only for Paul McNamara of Ernst & Young to comment that further work had been undertaken since the last meeting “in connection with the appropriate provision to be made”. The audit committee had clearly not been involved, and the only comment recorded was that of Headdon, who told the committee that the £200m provision for the technical reserves had been supported by Ernst & Young.

159. On 12 October 1999 the audit committee was told of the key areas of the audit focus, which include GARs, actuarial valuation and strains on solvency but there was no response recorded from the committee, apart from a discussion on the GAD reserving guidance for the GARs and the fact that these were not likely to be relaxed. The rest of the meeting discussed risk, which is addressed separately in this chapter.

160. On 7 March 2000, the audit committee was told that it was proposed by management that the provision for the GARs should remain at £200m in the 1999 accounts, as in 1998. Paul McNamara told the committee that Ernst & Young had reviewed the new actuarial valuation process and had no issues to raise in this regard, having been satisfied that the appointed actuary’s approach had been reasonable, including the monitoring of the Society’s solvency position

161. The regulatory returns were presented to the audit committee and next considered on 7 March 2000. The committee was told by Headdon that there were no changes to the regulations, that GAD had issued further guidance on reserving for GARs and that this was reflected in the returns. Leaving aside the GAR issue, the regulatory position presented by Ruth Loseby followed the established pattern. She gave a précis of the main features of the returns. It was remarkably similar to earlier years – the committee was told schedules 1 and 3 were subject to audit and the direct responsibility of directors; schedule 4 was the personal responsibility of the appointed actuary, and the directors responsibility in this matter was limited to ensuring it was prepared. Following this précis, the audit committee approved the returns. They were not asked to take decisions on the substance of the returns.

162. At no time, throughout the period from 1994 until 2000, did the audit committee consider in any detail the assumptions on which the liability valuation was based, not did it concern itself with the basis or justification for the actuarial assessment of the liabilities. With the benefit of hindsight, Tritton told the inquiry that he thought it would have been helpful to the non-executives if there had been a liabilities committee as well as an investment committee. That may be the case: a committee dedicated to the liability valuation might have focused more particularly on critical areas. But the liability valuation was an issue for the committee for statutory accounting purposes from the outset, and for regulatory purposes from 1996. The position appears to be that the committee was totally dependent on the actuaries for advice on what was material as well as advice on the solution of any problems that arose.

163. Indirect involvement with liability valuation, as a source of business risk, was also beyond the scope of the committee’s initial remit. As discussed above, the audit committee did not have a direct role in risk management. When the committee was established, at the start of 1994, there were no conventional risk management

systems in place. There were changes in the committee's remit in 1996 and 2000, but these did not specifically entitle the audit committee to look at risk. In 1996, the remit was extended to include review of internal control, and in 2000, the terms of reference were altered to specify that the audit committee should receive reports from the risk management group and should have an overall review of risk in relation to the report and accounts and other general matters.

164. The steps taken by Tritton and Davis to gain some information and control over the issue of risk management have been discussed. Over most of the period, instead of risk being a legitimate review topic for the audit committee, the executive retained control by making the responsibility for risk an executive matter, and formed exclusively executive committees to deal with it. These included the SCRG, the ICRT, and the RMG. These groups reported to the audit committee on an annual basis. There was a risk review in late 1998 by Ernst and Young and in early 2000 the RMG evolved into the business risk management group (BRMG) and the internal audit function.

165. The internal control functions that existed in the early 1990s did not extend to actuarial management of the Society. So far as they were in force, they were regarded as within the responsibility of senior management rather than the Board and its committees, and as a tool to monitor compliance with management systems. The risk of mis-judgement in assessing the assets and liabilities was not considered a control issue. In that context, the control function was limited to checking the existence of the items and that they were recorded at the correct amounts. Bowley's five principles of operational control, ("authorisation, recording, safeguarding, reconciliation, and valuation"), were the criteria the systems had to meet. There was no requirement to demonstrate compliance with defined business objectives. The Society was criticised by Ernst & Young in 1997 and 1999 for failing to operate risk management programmes from clear business objectives.

166. Periodic valuation of assets and liabilities was reviewed mechanistically rather than as a matter of substance, ensuring that recorded values met legislative and regulatory requirements and that errors and irregularities were detected. The actuaries' judgment on values was not subject to review.

167. In October 1997 the audit committee received the first annual report on internal control. The self-assessment exercise was described. It relied on the managers' own assessment of the system of controls under which they operated. The report was then reviewed by the SCRG, which reviewed "the adequacy of the controls stated". The review was entirely reliant on the managers' assessment: the SCRG did not undertake any independent analysis of the controls described. This was made explicit to the audit committee:

"It was stressed that the review by the SCRG did not attempt to test the actual responses made".

Dependence on management in undertaking the risk assessment was justified on the basis that:

"the review indicated that the self assessment exercise had been undertaken diligently by managers".

168. Examination of the risk list, in its several editions, revealed a pre-occupation with systems and data recording as tools for managing risk. Item 19, the valuation of liabilities, stated that risk lay in the possibility of incorrect data being recorded, leading to incorrect valuation. The valuation process was not identified as creating risk. Section 22, "guarantees which become onerous to the Society" focused on modern contracts, and made no mention of guaranteed explicit or implicit in older in-force business. It was not until 1998 that liability valuation and product risks (which included guarantees) came under review.

## **External Guidance**

### DTI Guidance on Governance

169. The Insurance Companies (Third Insurance Directives) Regulations 1994<sup>19</sup> amended the Insurance Companies Act 1982 inter alia to introduce amendments to the regulatory powers of intervention to include power to take action to ensure that the criterion of sound and prudent management was fulfilled<sup>20</sup>. The provisions came into force on 1 July 1994.

170. On 1 December 1994 the DTI wrote to all chief executives of authorised insurance companies drawing attention to the new power, and to implications for directors' certificates on regulatory returns. Two types of guidance were offered: 'systems of control' and 'preparation of returns'. For present purposes the former is relevant. The letter referred to a 'Systems of Control' series of guidance documents intended to set out the department's views on the issues to be taken into account in setting up and maintaining control systems. It was not intended to prescribe rules for the design of systems.

171. The letter enclosed a copy of Prudential Guidance Note 1994/6, effective in respect of financial years starting on or after 1 January 1995, and the first in the series of 'Systems of Control' guidance notes, dealing with investments and counterparty exposure. It referred to the explicit requirement in the Act, following implementation of the third insurance directives that companies be managed "in accordance with the principles of sound and prudent management". The criteria were set out in schedule 2A to the Act and included in paragraph 6(l)(b) of the schedule the statement that:

"The insurance company shall not be regarded as conducting its business in a sound and prudent manner unless it maintains adequate systems of control over its business and records."

The aim of "systems of control" guidance notes was to set out the issues which DTI believed it was important for directors to consider when setting up control systems. Compliance with the guidance was not compulsory. However, it was compulsory for directors to put in place adequate systems of control.

172. The 'Systems of Control' guidance emphasised that suitable control and management information systems should be in place to enable the company to implement an appropriate investment strategy, having regard to the statutory framework and any prudential guidance issued or endorsed by the DTI. It was emphasised that:

"19. In order to satisfy themselves that investment activity is carried out in accordance with the approved strategy and that adequate controls are in place, the Board of Directors will need to receive reports at an appropriate frequency with appropriate details as to the investment activities and controls."

173. The management of the Society prepared a response, dealing primarily with investment. In it they said:

"Investment strategy is determined by the Investment Committee within the broad parameters laid down by the Board. That Committee currently comprises four non-executive Directors, including the President and two Vice-Presidents, the Managing Director and the General Manager - Investments. It is also common to invite some Senior Investment and Property managers to attend the meetings. The Committee's function is in part an active policy setting-decision making body and in part a monitoring body. All Committee agenda papers are sent to all Directors of the Society. Minutes of the meetings are included in the agenda papers for the Board meeting immediately following the Investment Committee meeting, and thus are sent to all Directors.

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<sup>19</sup> SI 1994/1696.

<sup>20</sup> Section 45(1)(b) of the Insurance Companies Act 1982.

The Committee meets monthly, at which time it would discuss, and set, general investment strategies, and receive various standard and one-off reports, usually from Investment Managers.”

174. In relation to actuarial advice, the report stated:

“The Appointed Actuary reports formally to the Board on actuarial considerations affecting investment policy at least annually. Revenue data is reported monthly with a more formal quarterly review. The quarterly reviews include an updated assessment of any considerations affecting investment policy. The Board is then able, taking account of the advice of the Appointed Actuary, to set broad guidelines within which the Investment Committee should determine investment strategy.

The present Appointed Actuary is a member of the Investment Committee of the Board and participates in the formulation of investment policy. During the time before he was a director, he attended meetings of the Investment Committee and so was able to comment on the proposed investment policy as it was formulated. Future Appointed Actuaries may not, however, be members of the Investment Committee, but will nevertheless be invited to attend and participate in the meetings.”

175. Detailed discussion of the Society’s governance arrangements relating to investment were then set out. It was said that the management of the Society’s investments was at all material times carried out within the terms of the report. Investment judgments might be good or bad: there was market risk that could not be eliminated.

176. The 1994 provisions, and the guidance issued by DTI, focused the attention of boards and management formally on the over-arching responsibility of the directors of offices for the management of the business and for control of operations. But there had already been a general movement in that direction, and the Equitable Board had been pressing for change in the Society’s governance that would increase the effective supervision it exercised over management. In 1994 the process was slowly beginning, from a base level at which for all practical purposes control of risk relating to the Society’s products and liabilities had been vested exclusively in an executive management that was particularly resistant to change.

177. In terms of systems, the Society’s investment procedures appear to have been well-established and appropriate. For present purposes they presented a marked contrast to the management of liability-related risk. The control of investment activity provides a model against which to assess the effectiveness of control of liabilities and product design. The Society did not, at any material time, have an equivalent system of controls over the actuarial function.

#### The Smith Report

178. Sir Robert Smith’s report on audit committees sets out a modern model. It would not be appropriate to apply it as a test of the arrangements made by Equitable at any material time. But it indicates that in 2000 Equitable was approaching a standard of provision that was within striking distance of the Smith model of an effective audit committee. Its roles and responsibilities in relation to financial reporting covered changes in accounting policies and practices; major judgmental areas; significant adjustments arising from audit; the going concern assumption (though that was never a matter for serious consideration); compliance with accounting standards and compliance with legal standards. Risk management systems and internal financial controls were in place. Internal audit, in a modern edition, was under development. Communication with policyholders (the nearest equivalent to shareholders in the Smith model) was being addressed. Procedures and remuneration and other particular issues were already covered. Whistle-blowing was not adequately covered. But that presented the Society with particular difficulties in the most relevant area; the work of the actuarial department. The appointed actuary was under an obligation to report to the regulator if

circumstances demanded it. But other actuaries, including those on the Board, were inhibited by professional rules from undermining the authority of the appointed actuary.

179. The Society's extensive revision of its systems in 1999 and 2000, and the approach adopted then is perhaps the best measure of what had been required over a considerable period of time, and what could be achieved with reasonable expedition when there was a will. The report by Ernst & Young on risk management was received in the autumn of 1998. By early to mid 1999 it was agreed that a risk function, including an internal audit team, should be formed. The practical implementation of the proposals sets the context. Managers and staff were briefed in September 1999. The SCRG was disbanded in the autumn of 1999. In the autumn of 1999 recruitment began for a replacement for Hirst as assistant general manager. Hirst also began recruiting a professional internal auditor. He recruited Mike Davies from Royal Bank of Scotland, who joined in May 2000. Hirst's own replacement as AGM for accounting and financial control arrived in June 2000. The new risk function began operating in January 2000, when Soundy began reporting to Hirst.

180. The domestic solution developed by the Society in 2000 with the assistance of Ernst & Young was ample. Subject to reflecting generally accepted contemporary views, there appears to be no reason why the Society could not have developed a comprehensive audit committee function and associated internal audit at any time during the 1990s had there been the will so to do. It appears that the lack of progress towards that end can only be attributed to the intransigent resistance of the executive to what was regarded as an attempt by the Board, or particular members of it, to encroach on what had come to be regarded as management's exclusive area of interest. Having regard to the articles of association, the notion that delegation to the executive could ever be exclusive of the continuing supervision of the Board, and to recall should that course seem appropriate, was at all times wholly without foundation.

181. In retrospect, the conduct of the Society's audit committee would not have satisfied the criteria set out by Sir Robert Smith. One could hardly characterise the demand for a risk list and an active part in risk management as a 'robust stance'. The committee did receive information that there was a proper system of oversight and allocation of responsibilities for day to day monitoring of financial responsibilities. In many operational areas there was. But in relation to actuarial judgment, which was fundamental to stability of the business, there was not. Induction training does not appear to have extended to providing directors with a proper understanding of the dividing lines between the technical actuarial area and the exercise of discretionary powers dependent on that technical material. It appears to have been a particular conceit of the actuaries that the exercise of discretion was as much their exclusive preserve as the arithmetic that instructed it. In general it is the defining characteristic of an expert that he or she can communicate the results of his or her expertise with sufficient clarity to enable any reasonably intelligent person vested with a decision making power effectively to exercise that power. Actuaries need not be in an exceptional position in this respect, and life offices' boards can be as competent as others to reach decisions on the basis of intelligible advice.

182. However, in general the assertion of actuarial control over critical areas of the Society's business was consistent with the approach that had been adopted over time. And it can be illustrated by reference to two matters within the actuarial management area of activity.

### **The Actuarial Functions**

#### **Product Design**

183. In *With Profits Without Mystery*, the authors referred to actuarial involvement in product design, and its relationship to benefits. The structure of the benefits

provided by the Society's products was said to require the actuary to have a close involvement, and interest, in the marketing aspects of the business. It was said that the Society's actuaries would not regard as helpful an environment in which the actuarial involvement in product design was limited to narrow technical matters.

184. The rationale for actuarial involvement in product design, for the classes of business written by the Society, was made plain to the profession. In practical terms it was realised in almost total control over product design. In terms of governance, the issue was not whether actuaries should be involved in these areas. It was whether they should have control over the relevant areas to the exclusion of practical involvement of the Board. The Board papers contain repeated references to amended and to new products as events in the past. The extent of delegation of product design was illustrated in discussions in 1993. The Society had launched a new 'dread disease' product. On 22 September 1993 a question was asked about the product at a meeting of the Board. The minutes recorded that Ranson had indicated that the newly launched dread disease product was not seen as a material change in risk-taking especially as 50% of the risk was reassured. He also referred to the managed annuity product that had been launched. The Board 'noted' that there had been a press conference. Of the two products, the managed annuity was to prove difficult: the Inland Revenue required it to be withdrawn. Both products had been introduced without Board approval.

185. The same products were discussed again at a board meeting on 24 November 1993. Ranson said that the new products were within the normal format of the Society's business. The general manager for sales and marketing (Shaun Kinnis) assured the Board that the Society's core business would remain pensions, while meeting the obligation to offer a comprehensive range of products. Ranson undertook to consider the appropriate method to involve the Board in product design.

186. On 22 December 1993, the Board minutes record under the heading of "Principles of Operation of the Society":

"The Managing Director and Actuary drew attention to the fundamental principles of the operation of the business and reminded the Board how the Executive Management operates to develop new products. A Director explained his perception of the critical illness contract and while seeing that as only a marginally different form of contract, considered that it does take the Society into a particular form of illness insurance. He suggested that external perception should be considered when determining whether or not a new contract involves a move into a new field.

It was accepted that a move to a sickness (PHI) contract would certainly be a new field of operation for various reasons and the Managing Director and Actuary confirmed that such a contract as that would be presented to the Board if that kind of material move were to be proposed. However, for marginal moves of contract type, it was suggested that the Managing Director and Actuary should check with the President and that was agreed."

The director raising the question was Sherlock, by this stage a non-executive director of the Society.

187. Notwithstanding Sherlock's intervention, the Board made little progress in achieving a practical say in product development. The Board apparently accepted that whether or not it received information about new product proposals would depend, in the first place, on the actuary's view whether it involved a move into a new field, and in the second place, and in marginal cases only, on a discussion between the actuary and the president. The Society's business development was related to the production of innovative contracts appropriate to the requirements of its narrowly defined target market. The delegation of product design was all but comprehensive. As the discussion in *With Profits Without Mystery* indicated, there was a close relationship between product design and liabilities. The risks to which

the Society was exposed from time to time included product design risks, and of these, the Board was ill-informed.

#### Liability recognition and valuation

188. From 1973 onwards the actuaries presented extensive reports to the Board on the technicalities of liability valuation. For most of the relevant period it has been difficult to determine how and when important decisions about the Society's financial position were made. Particularly in the 1970s and 1980s minutes were brief and uninformative, and there is little or no evidence of any substantial discussion. The agenda remained largely unchanged and included some surprising items for a Board, such as the allocation of marriage bonuses, alongside what might have been expected to be more relevant and substantial issues. In the 1990s minutes were more full. But they still failed to record in any detail the background to more important changes in the business. Reports on liability valuation were formulaic, with the same headings being presented repeatedly with updated figures. There was relatively little background information on the reasons for particular actions or approaches. The valuation reports tended to be long, but lacked analysis and guidance on the decisions required of the Board. There is very little evidence of challenge.

189. In the early 1990s changes in GN1 required the appointed actuary to discuss with the Board the future financial position of the office. This does not appear to have happened on a regular basis until the later 1990s. In particular there does not appear to have been structured exploration of the future financial position of the Society on different scenarios. A combination of a low capital base, rapid expansion and continuing and potentially onerous guarantees would have made some relatively sophisticated modelling appropriate. There were well-developed stochastic techniques available throughout the 1990s. None was employed.

190. The extent of actuarial control over liabilities was illustrated late in the reference period. In July 1999 the Society and its legal advisers were engaged in preparations for the continuing *Hyman* litigation. The Society's solicitor commented on the need to establish a "paper trail" in relation to the Society's approach to the determination of surrender values and how this was documented and communicated. Headdon responded that the Board had delegated to him, as the appointed actuary, a unilateral power to determine surrender values. He said that he would probably mention a decision to apply a market value adjustment informally to Nash, but if Nash was on holiday or unavailable, he would apply the MVA anyway. He asserted that under GN1 surrender values had to be determined by the appointed actuary, though he did not point to any provision that in his view had such an effect.

191. A similar issue arose on 3 July 2000 in the context of transfer values. A particularly telling example of the actuaries' approach, already discussed at some length, was the treatment of the differential terminal bonus policy that led to the *Hyman* litigation. In December 1993 the board resolved to alter the formal statement of bonus that had been approved in February of that year: a matter within the exclusive competence of the Board. But, so far as the records of the Board's business disclose, there was never a decision to adopt the policy that was reflected in the statement, or any exploration of the potential guaranteed annuity rate problem and its possible implications, despite the evidence that within the actuarial team the 'solution' to the problem had been formulated as long ago as 1982-83. This was consistent with the view that the determination of the sums payable on policies was a matter that had been delegated to the actuaries to the effective exclusion of the Board.

192. The guaranteed annuity rate issue demonstrates the Board's dependence on the Society's actuaries for information and advice on the valuation of liabilities and the amount of the long-term fund. To a considerable extent that dependence was unavoidable: these are the specific areas of professional responsibility that one would expect to be treated as within the scope of the actuaries' duties to the Board.

The question whether the dependency was so extensive as to amount to total abrogation of the board's responsibility for this area of work is not within my remit. A full disclosure of the annuity guarantee risk was made only when the problem became public in 1998.

### **Conclusions**

193. The Higgs report emphasised the need to avoid a "one rule fits all" approach to corporate governance. The peculiar characteristics of the mutual life office emphasise the need for adaptation of any general rule to fit the demands of this business form. However, it goes further than that. The emphasis on the over-arching role of the company's constitution generally has particular relevance and importance in the case of the mutual life office. Many such companies have constitutional histories that reflect their origins, age, general conservatism in constitutional matters, and their adherence to ideas believed to have been inherited from the past. In this chapter the corporate governance of Equitable has been discussed: the Society may have been unique, however, and one would be slow to infer that there were or are general deficiencies based on this particular example. However, what the Society's position illustrates is what could happen, over a particular period and in particular circumstances, and what existing systems of corporate governance accommodated in the case of the Society.

194. The position reached in 2000 in the development of the Society's corporate governance systems was not perfect. It would be difficult to say that risk management had fully 'come of age'. Hirst told the inquiry what was covered. He said that the scope of the risk function covered strategic and operational risk, but not credit risk or actuarial risk (such as looking at liabilities). It did look at operational risk within the actuarial functions, that is the operational risk to the achievement of the actuarial functions' objectives. For example, how it would affect those functions and the achievement of their objectives if they lost key staff members. The loss of key staff would have had a related impact on the carrying out a critical function such as liability valuation. Whilst the function reported to him, there was no internal audit review of the actuarial function or the process for determining actuarial liabilities. He thought that if the internal audit function been in existence for longer, some review of the systems and procedures in the actuarial areas might well have been appropriate. But internal audit was only formed in May 2000. Only Ernst & Young took an interest in the actuarial function. Hirst's role in relation to risk management was to develop a methodology and to help in its implementation across the business. Individual risks remained the responsibility of department managers. He would help them with risk identification, evaluation of potential likelihood and impact, action planning, and monitoring to ensure that agreed actions were taken.

195. These developments involved radical changes in the management of risk within the Society. They represent a victory of modern management thought over entrenched opposition to change. In a real sense the new systems provide a measure of the deficiencies in the management systems they superseded. However, it appears reasonable to observe that even by 2000 it was not thought to be a practical proposition that actuarial risk should be monitored and managed. The guaranteed annuity problems, the over-allocation of bonus, and the manipulation of the impact of regulatory solvency by changed product design and by modification of actuarial assumptions in liability valuation would not have been identified at the stage that by then had been reached. Unless Hirst was correct in anticipating further change, these risks would have remained exclusively in the actuarial area, without independent management scrutiny. But there was, overall, a much more acceptable governance system in place internally, largely as a result of the need to respond to external pressures.

196. There is, however, nothing in the structure of a mutual life office to prevent a similar problem emerging. In the case of a proprietary office the market can exercise

considerable influence on management. Bancassurance and similar complex integrated financial services providers may break down the direct link between management of the life business and shareholder response. But it can reasonably be assumed that market forces will, in appropriate circumstances, react to management failure and, directly or indirectly, affect the sustainability of current policies. In a mutual with-profits office, the policyholders effectively enter into a joint venture with the equity shareholders, sharing in the profits and losses of the long-term business activity. If shareholders intervene in management in their own interests, the policyholders' interests are affected and will normally be taken into account. Regulators have been diligent to prevent shareholder interests being preferred disproportionately over those of policyholders in the past, and it is reasonable to believe that under the current regime that requires fair treatment of policyholders a similar approach would be adopted.

197. There is no external interest that can be relied on to protect the interests of policyholders of a mutual life office, and the policyholders themselves, though representing the proprietary interest in the organisation, are powerless. However, the mutual office has its foundations in contract, typically constituted by the articles of association of the society and the individual policies of its with-profits members. An acceptable statutory innovation on that contractual basis that would provide direct protection against management policy is difficult to imagine. It might be possible to provide for periodical review of the continuing acceptability of mutual status by requiring a poll of members. But the rigidity of any such provision would expose individual societies to chance, possibly wholly unrelated to any factor reflecting on the existing management or on current members' interests.

198. I have come to the view that the only acceptable approach to the many, and unpredictable, issues that are peculiar to the mutual life office is to ensure that they are subject to a level of regulatory scrutiny that takes account of the reality that, apart from the regulator, there is no-one who can intervene effectively to influence the activities of what must remain a form of organisation managed by a self-perpetuating oligarchy, selected on an unaccountable basis by current directors as their successors in office, and vulnerable to the influence and, in an extreme case, control of professional actuaries who are answerable, if at all, only to those same directors who are fundamentally dependent on their advice.

## **CHAPTER 10: ACCOUNTING FOR TERMINAL BONUS**

1. The pattern and amounts of payments made by the Society as terminal, or later final, bonus have been described. Later I shall comment on the question of policyholders' reasonable expectations in relation to the continued payment of terminal bonus values in the absence of a material change in the Society's financial position and market volatility. In this chapter, I shall discuss the legislative and regulatory background against which the Society accounted for these payments on a cash basis and focus on the question whether there was any requirement that the Society should have accrued for or otherwise acknowledged terminal/final bonus in the Companies Act (statutory) accounts or regulatory returns. The discussion is relevant to the audit of the Society's financial statements and to regulation.

### **Legislative Background**

2. Statutory protection of purchasers of life assurance products has a long history, anticipating by many decades the introduction of more general consumer protection legislation. In some respects the existence of a specific code may have inhibited the development of the regulatory and accounting requirements applicable to life business in parallel with developments in the wider business context, so that the particular protective provisions fell behind more general developments. In that respect, life business would not be unique: familiarity with an existing prescribed code may generate a complacency that becomes a powerful defensive barrier against change. The risk may be related to the degree of specialisation involved. The more narrowly focused and specialised the area of business, the more likely the participants are to regard established practices as sufficient, if not already over-prescriptive. A period of general commercial success, avoiding financial disaster, can easily persuade responsible officers that regulation is unnecessarily restrictive of management freedom.

3. The Life Assurance Act 1870 was enacted as a measure to protect policyholders after an unprecedented level of insolvency of life insurers, and required inter alia:

- i. The establishment of a separate long-term fund;
- ii. An actuarial investigation of the long-term fund every five years; and
- iii. The preparation of a revenue account and balance sheet each year in a prescribed form to be filed with the Board of Trade<sup>1</sup>.

The fundamental elements of the current regulatory regime, now characterised as the segregation of funds, the statutory functions of the actuary, and the requirement for filing a regulatory return, were introduced in these early provisions. In current form, the regulatory returns must be supported by certificates by an appointed actuary, the directors and the auditor. The requirement to carry out an actuarial investigation every five years changed to three years and then, under the Insurance Companies Act 1982, became annual. The returns were made to the regulatory body charged with the relevant statutory duties at the time, and that, for most of the relevant period, was the Department of Trade & Industry (DTI). The returns were available to the public and were the basis of the regulatory philosophy of 'freedom with disclosure' whereby life offices had a degree of discretion over the basis on which the returns were prepared, but were subject to such discipline as commentators and the markets might apply.

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<sup>1</sup> Responsibility for this aspect of 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. Responsibility was delegated to the Financial Services Authority (FSA) from 1999 to November 2001, and became the FSA's statutory responsibility from 1 December 2001 under the Financial Services and Markets Act 2000.

4. The earliest material statute for present purposes was the Insurance Companies Act 1982 ('1982 Act'). It contained the powers and duties of the regulator and prescribed the regulatory process.<sup>2</sup>

#### Valuation and Solvency, and Reporting Rules

5. Over the reference period there were numerous editions of regulations relating to the valuation of the assets and liabilities of insurance companies and to the preparation and submission of accounts and statements for regulatory purposes. These successively set out rules regarding the recognition and valuation of assets, and the principles for recognising and valuing liabilities, and prescribed the form of the accounts to be included in returns, certificates to be appended to the accounts and other matters. Some provisions, such as Regulation 2 of the Insurance Companies (Accounts and Forms) Regulations 1968 (which explain the role of the auditor as understood in the early 1970s), are dealt with in context where there is a particular point to be made. But in general I have taken the view that an extended historical analysis of the regulations is not necessary. The period of greatest interest in the Society's financial affairs lay largely in the 1980s and 1990s, and it is the regulatory structure over that period that requires discussion. For present purposes, the Insurance Companies Regulations 1981<sup>3</sup> ('1981 regulations') and 1994<sup>4</sup> ('1994 regulations'), and the Insurance Companies (Accounts and Statements) Regulations 1983<sup>5</sup> and 1996<sup>6</sup> ('1983 accounts regulations' and '1996 accounts regulations') are material in relation to the valuation of assets and the principles for valuing liabilities, determining the required minimum margin of solvency, and presentation of the accounts.

#### Solvency Margins

6. Section 32 of the 1982 Act required all offices carrying on insurance business in the UK to maintain a margin of solvency. The amount prescribed was determined by the regulations in force from time to time. 'Admissible assets' only were taken into account for solvency purposes. The actual margin of solvency was the excess of admissible assets over liabilities, each element being determined in accordance with the applicable regulations. The regulations stipulated that companies had to maintain a "required minimum margin" ('RMM') of solvency for regulatory purposes, and prescribed rules for determining that value. The relevant rules set out in part II of the 1981 regulations and part IV of the 1994 regulations, differed from those applicable in the preparation of the statutory accounts, and different levels of solvency were derived from the application of the two sets of rules. Failure to meet the regulatory required minimum margin of solvency empowered the Regulator to request that the company submit and implement a plan for the restoration of a sound financial position.

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<sup>2</sup> The following sections of part II of the Act are relevant to this chapter:

- § Section 17: *Annual accounts and balance sheets*. This required insurance companies to prepare annually a revenue account, balance sheet and profits and loss account.
- § Section 18: *Periodic actuarial investigations of company with long-term business*. This provision obliged insurance companies carrying on long-term business to have an annual investigation into the financial condition of the business. The investigation comprised: a valuation of the long-term business liabilities of the office, a determination of the excess of assets over liabilities and a determination of the extent of the profits arise which were considered distributable to policyholders.
- § Section 19: *Appointment of actuary by company with long-term business*. The investigations were to be performed by an appointed actuary.

<sup>3</sup> SI 1981/1654, 1 October 1982.

<sup>4</sup> SI 1994/1516, 1 July 1994.

<sup>5</sup> SI 1983/1811, 15 March 1984.

<sup>6</sup> SI 1996/943 (applicable to financial years ending on or after 23 December 1996).

Guarantee Fund: Minimum Margin

7. For long-term business, the insurer had to maintain a “guarantee fund,” which was defined in regulation 9 and regulation 22 of the 1981 and 1994 regulations respectively, in the case of mutual companies, as the higher of:

- i. One third of the required margin of solvency (provided that items which are not implicit items must cover the greater of the minimum guarantee fund and 50% of the guarantee fund); and
- ii. The minimum guarantee fund (ECU 600,000 or approx. £400,000).

The required minimum margin of solvency, calculated in terms of the regulations applicable from time to time, had to be maintained throughout the year.

8. These provisions were aimed at supporting the prudential objective of ensuring that companies could and would meet relevant liabilities to policyholders. Given the nature and duration of life policies, the valuation of liabilities was a complex process requiring the application of actuarial principles and practices. Accordingly, it was a statutory<sup>7</sup> requirement that the liabilities valuation (the long-term business provision) should be performed by a specified officer, the office’s appointed actuary. The work was performed during the actuary’s annual investigation into the financial condition of the office’s long-term business as required by the 1982 Act. This feature was unique and distinguished the accounting and reporting requirements imposed on an insurance company from those applying to general companies.

9. The computation of regulatory solvency required the valuation of the office’s assets and of its liabilities, in accordance with the applicable regulations, namely those contained in parts V and VI of the 1981 regulations and parts VIII and IX of the 1994 regulations. The appointed actuary’s statutory responsibility to the regulator did not extend to valuation of the assets. The directors’ certificate under schedule 6 part I of the 1983 and 1996 regulations respectively had to state that the value of the admissible assets of the company had been maintained at not less than the amount of the liabilities of the business.

10. In addition to complying with the requirements of the regulations, the actuary had also to comply with guidance issued by the Institute and Faculty of Actuaries. This guidance, so far as mandatory, was contained principally in guidance note GN1, which set out the professional responsibilities and duties of the actuary and, in effect, extended the formal requirements of the 1982 Act and the related regulations in a number of areas, supplemented by GN8 which was not mandatory, but reflected best practice. From 1993 appointed actuaries had to state that GN1 and GN8 had been complied with<sup>8</sup>. The interaction of the actuarial valuations and their bases and general accounting requirements was of fundamental importance.

11. The presentation of the Society’s liabilities in its financial statements has to be assessed in relation to the various requirements imposed on the process of determining the liabilities. Topics of specific interest in the period from 1990 to 2000, which is of particular interest to the inquiry, are:

- i. Recognition of liabilities (Long-term business provision);
- ii. Discounting of long-term liabilities;
- iii. Contractual guarantees and options;
- iv. Treatment of terminal/final bonus; and
- v. Policyholders’ reasonable expectations.

12. An actuarially determined long-term business provision was included in each of the statutory accounts and the regulatory returns. In the accounts, it was classified as the long-term business fund/technical provision. In the returns it was

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<sup>7</sup> Section 18 of the Insurance Companies Act 1982.

<sup>8</sup> For example, GN1, version 5, paragraph 4.1; and GN1, version 6, paragraph 2.6.

classified as the mathematical reserve. Different statutory and regulatory requirements, and different practices, applied in each case. In general the same base values were usually presented in each statement on the view that the statutory presentation could properly be taken to reflect the generally more prudent regulatory valuation. The statutory valuation would however exclude additional regulatory reserves such as resilience and other general reserves that would inflate the disclosed regulatory liability value. The assets valuation requirements of the regulatory return were not, however, replicated in the Companies Act accounts, and the overall regulatory position was therefore expected to be more prudent.

13. For returns purposes, section 18 of the 1982 Act<sup>9</sup> applied. The appointed actuary was required, in terms of regulations, to compute the long-term business provision of a life insurance company, on the basis of recognised actuarial methods, with due regard to actuarial principles. Consequently the appointed actuary was required to value long-term liabilities in accordance with the requirements contained in the 1981 regulations, and the 1994 regulations which later superseded them, and to have regard to the assets valuation brought out on an application of the regulatory rules.

#### The Insurance Companies Regulations

14. The 1981<sup>10</sup> and 1994<sup>11</sup> regulations set out rules regarding the principles for valuating liabilities. Regulation 54 of the 1981 regulations: *long-term liabilities* provided:

“The determination of the amount of long term liabilities (other than liabilities which have fallen due for payment before valuation date) shall be made on actuarial principles and shall make proper provision for all liabilities on prudent assumptions in regard to the relevant factors; and that amount shall in the aggregate not in any case be less than the amount calculated in accordance with regulations 55 to 64 below (which shall apply only to long term liabilities).”

15. The valuation principles reflected the net premium method: for normal annual premium contracts future premiums were taken into account to the extent appropriate to provide the specified benefits under the contract excluding future bonuses, with appropriate provision for expenses, acquisition expenses being subject to zillmerisation as appropriate, and subject to specified interest discount provisions. The long term-liabilities of the office were defined in regulation 50 of the 1981 regulations as:

“liabilities of an insurance company arising under or in connection with contracts for long term business.”

16. Regulation 52 provided that the amount of the long-term liabilities should be determined in accordance with generally accepted accounting concepts, bases and policies or other generally accepted methods appropriate for insurance companies. In determining that amount all contingent and prospective liabilities had to be taken into account, but not liabilities in respect of share capital.

17. These provisions were concerned with quantification. There were no supplementary provisions to assist in the recognition of liabilities, and in particular none that was referable to policyholders' reasonable expectations. The valuation rules reflected the view that exclusion of the profit element from future premiums allowed for the future emergence of surplus and thereby secured policyholders' expectations of future bonuses.

18. In the 1994 regulations there was a material change of language. So far as relevant for present purposes, the definition of long-term liabilities in regulation 58

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<sup>9</sup> Section 18, Periodic actuarial investigation of company with long-term business.

<sup>10</sup> SI 1981/1654, 1 October 1982.

<sup>11</sup> SI 1994/1516, 1 July 1994.

of the 1994 Regulations was the same as in the 1981 regulations. But regulation 64 provided, *inter alia*:

“(1) The determination of the amount of long term liabilities (other than liabilities which have fallen due for payment before the valuation date) shall be made on actuarial principles which have due regard to the reasonable expectations of policy holders and shall make proper provision for all liabilities on prudent assumptions that shall include appropriate margins for adverse deviation of the relevant factors.

(2) The determination shall take account of all prospective liabilities as determined by the policy conditions for each existing contract, taking credit for premiums payable after the valuation date.”

19. Neither the 1981 nor the 1994 regulations provided for the recognition of liabilities by reference to policyholders’ reasonable expectations. The 1994 regulations made reference to policyholders’ reasonable expectations. But the definition provision, defining liabilities in terms of liabilities arising ‘under or in connection with’ contracts, read with regulation 64(1) went no further than to require that, in the case of liabilities recognised in terms of regulation 58, quantification of the liability for the purposes of the returns was to take into account, *inter alia*, of policyholders’ reasonable expectations. In Skerman’s seminal paper on valuation<sup>12</sup>, contractual liabilities were recognised: future bonus expectations were reflected in the net premium basis of valuation by limiting the future premiums that were taken into account to those necessary to provide the contractual liabilities.

20. The view that contractual liabilities alone were envisaged is strengthened by the terms of regulation 64(2) and (3). Regulation 64(2) dealt with prospective liabilities “as determined by the policy conditions” for each existing contract. It is relatively easy to identify examples that provide content for the provision. Equitable’s personal pension contracts from July 1988 until 1996 provided expressly for an investment roll-up rate of return (GIR) of 3½% per annum on premiums net of expenses. That, on any view, was a prospective liability of the Society determined by the policy conditions. All future bonuses, on the other hand, were, in terms of the policy conditions, dependent on allotment by the Board ‘by way of addition to or bonus thereon’, directly in terms of the earliest retirement annuity contracts, or by way of the definition of ‘related bonuses’ in later forms. While there are arguments on the formulations used by the Society in and after 1989, it would be straining the language of the Society’s publications and notices as a whole to say that terminal bonus was a liability ‘as determined by the policy conditions’. The terms of the contract documents, which I have discussed in chapter 2, drew a clear distinction between benefits that were liabilities in terms of the policy conditions and benefits that were not.

### Third Life Directive

21. The 1994 regulations implemented the 3<sup>rd</sup> life directive<sup>13</sup>. On 29 August 1990 the single market directorate general of the European Commission (DG XV) issued a working document in completion of the internal market in life assurance. The document proposed a basis for a third life insurance directive that would introduce a comparable ‘single licence’ or ‘passport’ regime to the regime agreed for banks in 1989. As with other market-opening measures, a degree of harmonisation was also proposed. Among other things, the Commission proposed “to harmonise the general principles on which technical reserves are calculated” rather than seek “to apply detailed rules”.

<sup>12</sup> A Solvency Standard for Life Assurance Business, R Skerman, the Journal, 1966, to which I shall refer later in discussing policyholders’ reasonable expectations. See chapter 13, paragraphs 34 to 37. Also paragraph 36 below.

<sup>13</sup> Council Directive 92/96/EEC.

22. The basis for harmonisation was to be the five actuarial principles for calculation of technical reserves already proposed by the '*Groupe Consultatif*'<sup>14</sup>. These principles included the following:

“(a) ... the technical provisions should be calculated on a suitably prudent basis, and not on a ‘best estimate’ basis.

(b) The calculation of technical reserves should take into account all the benefits guaranteed to be available under the conditions of the policy; this would include, for example, the provision of guaranteed surrender values; the detailed principles should require the technical reserves to be at least as great as any surrender value guaranteed.

(c) The calculation of technical reserves should take into account the reasonable expectations of policyholders in respect of future bonuses and terminal bonuses; it should be made clear that this does not mean that the insurance company should be able to pay on its present scales indefinitely, but that the method of distribution of bonus will continue to take account of the ‘surplus’ or ‘profit’ on interest, mortality, expenses etc in the same sort of way as the present method, whatever that method may be.”

Principle (d) concerned non-discrimination between domestic and “non-domestic” policyholders, while principle (e) said that the method of calculation of technical reserves for liabilities should be compatible with the method of valuation of the corresponding assets.

23. The third principle, (c), was explicit in its reference to policyholders’ reasonable expectations and the need to provide for future bonuses by reference to current practice. I understand that the drafting of this principle may have been heavily influenced by the UK representative on the *Groupe Consultatif*.

24. A draft directive was subsequently issued by the Commission on 29 October 1990. Article 15, in which the five principles had become six, proposed to replace article 17 of the first life directive. The proposed new article 17 would read:

“The home Member State shall require every insurance undertaking to establish sufficient technical provisions, including mathematical provisions in respect of its entire business.

The amount of such technical provisions shall be determined according to the following principles:

1.(i) The amount of such technical provisions shall be calculated by a sufficiently prudent actuarial valuation of all future liabilities for all existing policies, including:

- š guaranteed benefits, including guaranteed surrender values ...
- š bonuses which have already been guaranteed, whether described as vested, declared or allotted;
- š options available to the policyholder under the terms of the contract;
- š future expenses including commissions;

taking credit for the premiums which are due to be paid under the terms of each policy. ...”

Principle 2 provided that the rate of interest to be used in calculating the technical provisions should be chosen prudently, taking account the currency in which the policy[ies] denominated, and having regard to the yield on the corresponding existing assets and to the yield which it is expected will be obtained on sums to be invested in the future.”

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<sup>14</sup> *Le Groupe Consultatif des Associations d'Actuaires des Pays des Communautés Européennes.*

Principle 3 required the prudent selection of the basis for calculating provisions for expenses. Principle 4 dealt with future bonuses for with-profits policies thus:

“In the case of participating policies, the valuation method shall take into account, either implicitly or explicitly, future bonuses of all kinds, in a manner consistent with the other assumptions on future bonuses of all kinds, in a manner consistent with the other assumptions on future experience and with the current method of distribution of bonus. Where no explicit allowance is made for future bonuses a technical rate of interest shall be used that is lower than the rate chosen according to principle 2 by an appropriate amount.”

Principle 5 provided for prudent allowance for future profits, while principle 6 required that:

“The method of calculation of technical provisions from year to year shall be such as to recognise profit in an appropriate way over the duration of each policy, and shall not be subject to discontinuities arising from arbitrary changes to the valuation basis.”

Some of the drafting changed in a second draft issued on 18 January 1991 (the principles were again re-designated, this time from A to F), but these provisions were essentially unchanged.

25. The directive was formally adopted by the Commission as a proposal on 20 February. An accompanying Commission explanatory memorandum noted that:

“As regards the definition and calculation of technical provisions, this proposal for a Directive establishes co-ordination on the basis of actuarial principles that have to be respected by every insurance undertaking.”

It went on to record the conclusion of the *Groupe Consultatif* that harmonization on the basis of the principles would be “sufficient to ensure effective protection of lives assured in the context of a single licence system”. The new article 17 therefore laid down “sound and prudent principles” on the basis of the suggestions from the *Groupe Consultatif*. However, it was noted that, even after the proposed harmonisation:

“... there will remain a large number of actuarial methods and bases capable of satisfying these principles. Paragraph 2 of this article therefore provides that the methods and bases used by each undertaking must be published. Even if this information is too technical to be readily understood by most policyholders, the mere fact that it is freely available is an added inducement to the undertaking to exercise prudence.”

The idea of ‘freedom with disclosure’, for long a principle applied in domestic regulation, also underpinned the harmonisation proposed by the Commission.

26. An internal Treasury memo of 18 June 1991 noted that DTI believed that other Member States (unspecified) were likely to propose a more cautious approach on articles 15 (the new article 17 on technical reserves) and 16 (premiums for new business) that could lead to “over-cautious reserving and higher premiums”.

27. The first substantive discussion of these provisions took place at a Council working group meeting in Brussels on 9 and 10 January 1992. There was, according to the DTI note of the meeting, “a great deal of confusion” about the purpose of the principle concerning future bonuses (now principle D). The UK delegation explained to the working group that the provision reflected the system in the UK and Ireland, where with-profits policies were valued using a lower interest rate than other policies. It was suggested that, so long as this was adequately dealt with under the first principle, perhaps principle D was unnecessary.

28. During the same discussion the German delegation proposed that supervisory authorities should be required to set a maximum interest rate for valuation, a proposal that would dominate discussions on this part of the directive. This was picked up in alternative proposals for changes to the text from the German and

French delegations tabled for the next working group meeting on 20 and 21 January. The German proposal would have required the home State authorities to set a maximum rate after consultation with the relevant monetary authority and sought to give the EU Insurance Committee a role in the setting of these maxima. The French proposal went further in setting criteria for the maximum rate. The UK delegation “led the resistance” to both. DTI advice to the Minister for Consumer Affairs reveals a concern that a single rate “would simply not fit” the range of contracts sold in the UK. A UK paper was subsequently tabled on 5 February ahead of another 2-day working group meeting and bilateral discussions were held with the Germans and French.

29. On 21 February the Council circulated a revised draft directive. Principle A(i) was revised to read:

“A (i) The amount of the technical life assurance provisions shall be calculated by a sufficiently prudent prospective valuation of all future liabilities in accordance with the conditions laid down for each existing policy, including ...”<sup>15</sup>

This wording had been proposed by the Presidency at the working group on 9 January, though it is unclear from the papers the inquiry has seen at whose request the words “in accordance with the conditions laid down for each existing policy” were included. A Presidency proposal was also included on the maximum interest rate, which would simply have required home member States to set a maximum. And a number of scrutiny reserves were noted on principle D.

30. The UK delegation questioned the new wording for principle A(i) at the next working group meeting on 5 and 6 March. It was agreed that the word ‘actuarial’ would be reinserted before ‘valuation’, but no explanation was forthcoming for the Presidency’s additional words. The UK and Italy withdrew their reservations on principle D, but four scrutiny reserves were maintained<sup>16</sup>. At the working group meeting on 16-17 March the focus switched back to the maximum interest rate debate on which the Presidency had proposed a second compromise, less attractive to the UK delegation than the first. There were no significant changes to the relevant provisions in the draft directive circulated by the Council secretariat on 20 March, and the debate dominated again at the meeting on 30-31 March, with the UK still supported by the Netherlands, Ireland and the Commission. Again there were no significant changes to the text of 3 April.

31. At an ‘ad hoc’ meeting of financial attachés on 9 April<sup>17</sup>, a third Presidency text (this time devised by France and the UK) was proposed that offered the prospect of progress on this issue. At a further meeting of the attachés on 27 April it was noted that nine of twelve Member States could accept, and it was decided to refer the whole draft compromise text and remaining issues to a meeting of deputy permanent representatives on 5 May. The UK note of the meeting records that in the course of the discussion on 27 April the Netherlands proposed that if the Presidency text on principle B (maximum interest rates) was acceptable, principle D (the text on future bonuses) was no longer necessary. The Commission disagreed and proposed instead that only the second sentence of principle D (the part of the text requiring a lower interest rate to be applied where no explicit allowance for future bonuses was made) should be deleted. It was noted in the official Council note that some delegations still had doubts over this provision, and that the Commission had proposed the deletion of the second sentence as a compromise.

32. At the meeting of deputy permanent representatives on 5 May a compromise was agreed on maximum interest rates, and according to the official UK telegram it was agreed not only that the second sentence of principle D should be dropped, but

<sup>15</sup> Changes highlighted in original.

<sup>16</sup> France, Belgium, the Netherlands and Spain.

<sup>17</sup> In this context ‘ad hoc’ signifies that policy experts from the relevant ministries could attend as well as the attachés from permanent representations.

also that the provision should become “optional in character”. The official Council secretariat note of the meeting that was circulated with a revised text on 8 May in preparation for a discussion at the Internal Market Council on 14 May made no mention of this conclusion, which appears to have been regarded as a minor consequential amendment. The inquiry has seen no papers that explain at whose suggestion the provision was made optional<sup>18</sup>. The text that was circulated on 8 May duly omitted the second sentence of principle D and made the requirement to take account of future bonuses permissive rather than mandatory by replacing “shall” with “may”. Thus principle D now read:

“In the case of participating policies, the method of calculation for technical provisions may take into account, either implicitly or explicitly, future bonuses of all kinds, in a manner consistent with the other assumptions on future experience and with the current method of distribution of bonus.”

Political agreement was reached at the Internal Market Council.

33. The text appears unaltered following a subsequent meeting of jurist/linguists, but the wording of principle A(i) seems unaccountably strengthened in the common position text circulated by the Council secretariat on 15 June. It now read:

“A (i) The amount of the technical life-assurance provisions shall be calculated by a sufficiently prudent prospective actuarial valuation, taking account of all future liabilities as determined by the policy conditions for each existing policy, including ...”<sup>19</sup>

Principle D on future bonuses remained unchanged from the optional text put to the Internal Market Council.

#### Implementation of the Third Life Directive

34. The 1994 regulations brought forward the 1981 definitions of ‘long term liabilities’, provision for the amount of liabilities to be determined in accordance with generally accepted accounting principles, and the stipulation that all contingent and prospective should be taken into account. However, as indicated above, regulation 64 limited the determination of the amount of long-term liabilities to prospective liabilities as determined by the policy conditions. The UK did not take advantage of principle D to introduce a requirement for prudent reserving for future terminal bonus payments.

35. In summary, the position under the 1994 regulations was that the factors to be taken into account in calculating the minimum statutory solvency basis were:

- i. Sufficient provision had to be made for liabilities to ensure that, assuming the office’s actual experience was as favourable as the valuation assumptions, no further capital was required to support policies.
- ii. The maximum valuation rates of interest had to have regard to the yields on the existing assets attributable to the long-term business and, to an appropriate extent, the expected future yield. In particular:
  - a. Assets must be valued in terms of the 1994 Regulations;
  - b. Certain asset yields might be limited in accordance with the 1994 Regulations;
  - c. Adjustments were to be made for the risk that income and capital repayments might not be received as expected; and
  - d. The rate of interest could not exceed 97.5% of the actual weighted average adjusted yield on the assets.

<sup>18</sup> Although the inquiry has seen professional actuarial papers that suggest that this was seen as a significant concession gained by the UK, see chapter 13, paragraph 97.

<sup>19</sup> Highlighting added.

- iii. Prudent mortality tables were to be used taking into account the company's own past experience and published tables.
- iv. Provision was to be made for the excess of future expenses over the future policy margins on existing contracts taking into account past experience and expected future inflation.
- v. Options and guarantees were to be allowed for.
- vi. No allowance was to be made for any potential reduction in liabilities due to lapses.
- vii. Negative policy values were excluded, and
- viii. Account had to be taken of the nature and terms of the assets backing the long-term fund and of the effects of possible future changes in the values of these assets and their adequacy to meet liabilities (i.e. the resilience test – sensitivity analysis).

36. These requirements effectively imposed a minimum reserve on a net premium basis. For with-profits business, there was a further requirement that if a gross premium basis were used, the value of liabilities must at least be as great as those that would be produced using the net premium method. However, as a matter of requirement, the whole computation was related to contractual liabilities. The selection of the net premium basis of valuing liabilities was originally supported on the ground that it allowed for the managed release of future surplus and met policyholders' reasonable expectations of future bonuses. The language echoed Ronald Skerman's original principles of valuation, and in particular the first principle that supported the net premium basis of valuation<sup>20</sup>.

37. In the result, the 1994 regulations did not require the recognition of liabilities based on the quantification of accrued terminal bonus, either absolutely as a reflection of the reality of management of the insurance enterprise, or as a reflection of policyholders' reasonable expectations. The regulations stated that the liability should be determined in accordance with generally accepted accounting practice and methods appropriate for insurance companies, provided that the amount provided for in the regulatory return should not be less than the statutory minimum basis. As compared with the basis of the statutory accounts, it would appear that the regulations required that the minimum basis assumed a more conservative value, while the statutory accounts were prepared on the assumption that the entity was a going concern, and that that was the fundamental difference between the two bases.

38. I shall discuss later the reasonable expectations generated by the Society's references to allotted and accrued terminal bonuses in notices, correspondence and publications. For present purposes, I consider that it is clear that nothing said by the Society established policyholders' reasonable expectations of future and in particular terminal bonuses as prospective liabilities as 'defined by policy conditions'. The specification of this class of liabilities in regulation 64(2) of the 1994 regulations effectively excluded cases where there was not a defined contractual basis. The specific examples selected for illustration of long-term liabilities in regulation 64(3) point even more strongly in that direction<sup>21</sup>. One might be forgiven for wondering why it was necessary to identify 'guaranteed benefits' as liabilities at

<sup>20</sup> Skerman, 1966. See paragraph 19 above and chapter 13, paragraph 36.

<sup>21</sup> "(3) Without prejudice to the generality of paragraph (1) above, the amount of the long term liabilities was to be determined in compliance with each of regulations 65 to 75 and was to take into account, inter alia, the following factors:

- a. all guaranteed benefits, including guaranteed surrender values;
- b. vested, declared or allotted bonuses to which policy holders were already either collectively or individually contractually entitled;
- c. all options available to the policy holder under the terms of the contract; and
- d. expenses, including commissions."

all: there was no other way of understanding the term. The same applies to the references to vested, declared and allotted benefits ‘to which policyholders are already ... contractually entitled’. However, the specification of these benefits at least suggests that the regulation did not have in contemplation a possible benefit that might never mature, or if it did mature might be of value considerably less or more than currently anticipated because of external market conditions.

### **Accounting standards and guidance**

39. The discussion so far has left out of account sub-paragraphs (1) and (2) of paragraphs 52 and 60 of the 1981 and 1994 regulations respectively which, as noted above, provided that the amount of liabilities in respect of long term business was to be determined in accordance with generally accepted accounting concepts, bases and policies or other generally accepted methods appropriate for insurance companies, and that all contingent and prospective liabilities were to be taken into account. I shall return to the implications of these provisions after discussing the Companies Act accounting requirements.

40. Until the Companies Act 1948 came into force, insurers were permitted to file regulatory returns in lieu of financial statements. The 1948 Act prescribed few rules governing the form and content of financial statements, but required that such statements should give a ‘true and fair view’ of the entity’s state of affairs and profit or loss for the relevant accounting period. The Cohen Committee on company law considered that it was in the public interest that certain financial companies, including insurance companies, should be permitted to maintain undisclosed reserves. Mechanically, this translated into authority to include reserves in the liability provisions shown on the face of the balance sheet. The liabilities were inflated, and the general reserves of the company reduced accordingly. The company’s resources available to distribute bonuses, and in the case of proprietary companies dividends, were understated. Exposure to the risk of demands for increased distributions was reduced.

41. This structure was repeated in the Companies Act 1985 which was in force for most of the material period. General companies were required to prepare financial statements in terms of schedule 4 to the Act. Insurers were permitted to prepare annual financial statements in accordance with schedule 9. Schedule 9 contained modifications of and exemptions from the provisions applying to general companies that relieved insurance companies from the duty to disclose amounts of or movements in provisions or reserves.

42. The 1985 Act required the directors of all companies to prepare accounts which showed a ‘true and fair view’ of the company’s state of affairs at the end of the financial year and of its results for the financial year then ended<sup>22</sup>. The true and fair requirement was central to the regulation and control of financial reporting. All

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<sup>22</sup> In Accounting Provisions of the Companies Act 1985, Johnson & Patient, paragraph 3.09/10, p24. The legal consultant editor was Mary Arden, now Lady Justice Arden. The ‘true and fair’ requirement was reiterated as follows:

“All financial statements drawn up under the Act (CA) must present a true and fair view [Sec 228(2)]. This requirement is fundamental. It overrides the requirements of Schedule 4 (which contains detailed rules on the format and content of company financial statements) and all other requirements of the CA as to matters to be included in a company’s financial statements [Sec 228(3)].

The Act illustrates the circumstances in which the true and fair override will come into play. Section 228(4) of the Act states that, where information additional to that which the Act requires is needed for the financial statements to give a true and fair view, those financial statements must include that additional information. Section 228(5) then goes on to provide that a company must depart from that requirement if its circumstances are such that, if it complied with a particular requirement of the Act, and even if it gave additional information, this would not result in a true and fair view.”

financial statements had to be prepared on a basis that sought to achieve this requirement. In the case of general companies, making appropriate provision for a company's liabilities has at all times had to be considered in the context of this requirement. A company's statutory accounts may not be deemed to be true and fair as a whole if the company's liabilities are materially under- or over-stated.

43. The provisions relating to 'special category companies', such as insurance companies, were intended to adapt the general rules to the requirements of their businesses. The Companies Act 1985 permitted special category companies to elect between preparing accounts in terms of the general requirements of the Act set out in schedule 4 or applying the special provisions of sections 258 to 262 of, and schedule 9 to the Act as amended from time to time. The effect of the exemptions provided by schedule 9 was defined negatively. Where the schedule 9 exemptions were adopted, the financial statements would not be deemed not to give a true and fair view as required by the Act, by reason only that they did not give the information required by the provisions from which they were exempt.

44. The basic requirements were developed over time in primary and secondary legislation, and in published statements of recognised professional practice. Companies were required to have regard to rules contained in statements of standard accounting practice ('SSAPs', the then prevailing standards) and in other authoritative accounting statements such as industry statements of recommended practice ('SORPs') and emerging practices such as exposure drafts ('EDs'). The accounting records maintained by companies had to be sufficient to enable the directors to prepare financial statements that complied with those prescriptive rules and where appropriate took account of issued guidance.

45. Financial statements prepared by special category companies in accordance with schedule 9 had to contain a statement that they had been prepared in compliance with chapter II of part VII of schedule 9 to the Act. The accepted view was that special category companies were bound by the overriding requirement that the balance sheet and the profit and loss account must give a true and fair view of the company's state of affairs and the profit or loss for the financial period. The requirement that the balance sheet and profit and loss account must comply with the provisions of schedule 9 was without prejudice to any other requirements of the Act. Some special category companies were exempt from many of the requirements even of schedule 9. Where these exemptions were adopted the financial statements were not deemed not to give a true and fair view as required by the Act by reason only that they did not give the information required by the provisions of schedule 9 from which they were exempt.

46. Subject to any directions by the Secretary of State, an insurance company that was a special category company might take advantage of specified exemptions. In its balance sheet, an insurance company did not require, in respect of liabilities and reserves, to classify reserves, provisions, liabilities or assets under suitable headings, or show the aggregate amounts of reserves and provisions and the movements on such reserves and provisions during the year, or give the details of any other contingent liabilities. If an insurance company took advantage of the exemption from stating its reserves and provisions separately or describing them as such, its financial statements had to identify any heading in the balance sheet that contained a reserve or provision. In respect of the profit and loss account, exemptions relevant for present purposes provide that an insurance company need not give details of the amount set aside to, or proposed to be set aside to, or withdrawn from, reserves or provisions. If an insurance company took advantage of the exemption from stating its reserves and provisions separately or describing them as such, its financial statements had to explain how such reserves and provisions had been treated in the profit and loss account.

47. In general terms, the objective of a company's statutory accounts is well understood:

The objective of financial statements is to provide information about the reporting entity's financial performance and financial position that is useful to a wide range of users for assessing the stewardship of the entity's management and for making economic decisions.

That objective can usually be met by focusing exclusively on the information needs of present and potential investors, the defining class of user. Present and potential investors need information about the reporting entity's financial performance and financial position that is useful to them in evaluating the entity's ability to generate cash and in assessing the entity's financial adaptability."

Though formulated with shareholders in mind, the comment is equally pertinent as a statement of the objective appropriate to members of a mutual life insurer.

48. The accepted view of the 'true and fair' requirement following its introduction in the 1948 Act had been moulded by legal advice obtained on the instructions of the Accounting Standards Committee (ASC). It was treated as a dynamic criterion, reflecting circumstances, but broadly requiring that financial statements should provide information of a quality and quantity sufficient to satisfy users' reasonable expectations. Those expectations were reflected in and moulded by accounting practice, and in particular had regard to accounting standards of general application and professional guidance. It was expected that the courts would have regard to such statements as a measure of whether accounts gave a true and fair view of the matters stipulated in the Act.

#### Accounting Standards Board

49. Practical implementation of the statutory provisions required the development of accounting and other standards for the preparation of general companies', and special companies' accounts. The responsibility for developing standards has changed over time. Until August 1990 the responsibility for developing accounting standards was discharged by the ASC. Since August 1990 that responsibility has been discharged by the Accounting Standards Board (ASB).

50. The Foreword to Accounting Standards approved by the ASB described in particular the circumstances in which accounts are expected to comply with accounting standards. Notwithstanding its date, it described the position that obtained over the earlier period of the ASC's jurisdiction. Paragraph 16 states:

"Accounting standards are authoritative statements of how particular types of transaction and other events should be reflected in the financial statements and accordingly compliance with accounting standards will normally be necessary for financial statements to give a true and fair view.

An extensive process of investigation and consultation precedes the issue of a standard and the major accountancy bodies expect their members to observe the resulting statements as a measure of professional duty. Apparent failure by members to observe standards or ensure adequate disclosure of departures from them may result in disciplinary proceedings."

51. The foreword described the role of accounting standards as identifying proper accounting practice for the benefit of preparers and auditors of accounts. It referred to the provisions of the Companies Act 1989 that gave statutory recognition to the accounting standards and by implication to their beneficial role in financial reporting for general and special category companies.

52. SSAPs issued by the ASC and, subsequently, financial reporting standards (FRSs) issued by the ASB were applicable to all financial statements intended to give a true and fair view. Such standards could not and did not override statutory exemptions available to, and utilised by, life offices. Furthermore, certain standards modified the application of the general standards in their application to insurers or exempted insurers from certain of the requirements.

53. These domestic arrangements had to be related to the wider international context of developing accounting standards. The accounting professions' position was that:

“FRSs are formulated with due regard to the international developments. The Board (ASB) supports the International Accounting Standards Committee in its aim to harmonise international financial reporting. As part of this support an FRS contains a section explaining how it relates to the International Accounting Standards (IAS) dealing with the same topic. In most cases, compliance with an FRS automatically ensures compliance with the relevant IAS. Where the requirements of an accounting standard and an IAS differ, the accounting standard should be followed by entities reporting within the area of application of the Board's accounting standards.”

54. The centrality of authoritative published standards in securing compliance with the statutory criterion of 'true and fair' financial reporting could hardly have been expressed more forcibly than it has been by the representative bodies' statements. They were intended to form a central role in the preparation of financial statements. They were intended to guide auditors and others in the examination of financial statements and expressing professional views on them. It is against this background that one of necessity has to examine the state of play in relation to insurance accounting.

55. The position can be stated starkly. There are no UK accounting standards that specifically relate to insurance companies. So far as accounting standards are concerned, the insurance industry largely escaped accounting regulation. Some general standards specifically exempted insurers from certain of their requirements<sup>23</sup>.

#### SORPs

56. The Association of British Insurers (ABI)<sup>24</sup> has published four SORPs on accounting for insurance business. The first 'Statement of Recommended Practice on Accounting for Insurance Business' was issued in December 1986. The second SORP was issued in May 1990, and the third in December 1998. The fourth SORP was recently published in November 2003. The objective in each case was to set out current best accounting practice incorporating the insurance industry's many unique features. This guidance was issued in order to implement general accounting standards more effectively.

57. Prior to the first issue, annual financial statements were prepared more on a compliance basis than with the object of presenting a true and fair view. The exemptions provided in schedule 9, if utilised, overrode the requirements of any SSAP. Insurance businesses were required to adhere to the accounting concepts of going concern, accruals, consistency and prudence<sup>25</sup>. However prudence was thought to override the accruals basis in certain circumstances. For example, the prudence concept accommodated the use of precautionary 'margins' in the estimation of liabilities to create hidden reserves that would have been precluded by the accruals basis applying to general companies.

58. The long-term business provision in life companies accounts had to be calculated by an actuary. The 1982 Act contained an explicit requirement that the long-term business provision be computed by the appointed actuary for regulatory purposes. A parallel requirement was only made explicit for statutory accounts purposes in the 1985 Act as amended on the adoption of the requirements of the third life directive. The actuary was required by the amended provisions<sup>26</sup> to

<sup>23</sup> SSAP 19; FRS 1 and FRS 3.

<sup>24</sup> Formerly known as the British Insurance Association (BIA). It was as the BIA that they published the first SORP.

<sup>25</sup> SSAP 2.

<sup>26</sup> Paragraph 46 of schedule 9A to the Companies Act 1985.

compute the long-term business provision on the basis of recognised actuarial methods, with due regard to the actuarial principles laid down by the third life directive. However, generally, the actuary was obliged to comply with both legislation and guidance issued by the actuarial profession when performing the liabilities valuation. From 1986, the prevailing view was that departure from accounting concepts did not require to be disclosed because of the actuary's obligations in this respect. In relation to the valuation of the long-term business liability, this qualified the general rule that (with certain exceptions) any departure from fundamental accounting concepts required to be disclosed.

59. The preparation and publication of the first SORP did not follow accepted consultative procedures. Description of a statement as a 'SORP' implied that the consultation procedures specified by the ASC had been followed and that the ASC had approved the statement. In the case of a SORP published after due procedure, the practice of the ASC was to publish a statement that the Committee did not consider that the statement was in conflict with accounting standards. The first SORP was not endorsed, and did not achieve general recognition: it was guidance for the Association's own members only. In terms of content, the first SORP was directed to improving the quality of information disclosed in accounts rather than the accounting principles to be used. Consequently it did not address fundamental accounting issues (including accounting for investments), which arose from the statutory exemptions available to insurers. In the case of life insurers, the SORP endorsed the use of figures in the regulatory returns for the purposes of the Accounts.

60. The second issue of the SORP in May 1990 had the approval of the ASC and set out the recommendations intended to represent current best practice in respect of the form and content of accounts. Although SORPs were not mandatory, entities falling within their scope were encouraged to follow them and to state in their Accounts that they had done so. Profit as reported by many insurers did not reflect nor have any bearing on the successes and performance of a business in the current year. Consequently a more realistic profit performance basis was sought.

61. The second SORP addressed the accounting treatment of investments. In addition it dealt with the issue of the valuation of long-term liabilities, based on the statutory basis of valuation of long-term liabilities modified to reflect quantified actuarial surpluses as reserves, rather than generally accepted accounting practice. The method was known as the 'modified statutory basis', or the 'modified statutory solvency basis' (MSSB). This approach could in some cases result in financial statements being prepared on a true and fair basis, but cautious actuarial practice tended to result in conservative provisions for liabilities and consequent understatement of reserves.

62. The ABI recognised the accounting issue that arose, which was resulting, amongst other things, in published financial statements failing to provide investment analysts and other commentators with the information they needed. Consequently the ABI proposed that life office accounts should have profit reported on the basis of change in embedded value during the year. The embedded value method placed a value on the in-force portfolio of policies and accordingly reflected the present value of the whole of the profits expected over the life of the policy at inception. Thus profit would be recognised as the annual movement in this value.

63. The embedded value method was however not generally agreed to be compatible with accepted accounting principles and accordingly it could not comply with the requirements of the insurance accounts directive<sup>27</sup>. Even if, on a technical basis, the ABI's proposed method had complied with the law, it would have failed to meet the need for an accounting solution in which the constituent elements of embedded value were appropriately accounted for. Additionally, the ABI's proposal applied to group accounts which meant that subsidiaries could prepare their

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<sup>27</sup> Council Directive 91/674/EEC.

accounts on different bases which would result in fundamentally different true and fair views being brought together at a group level. It was thought by some commentators that the appropriate accounting treatment required to achieve a true and fair view would bring a “realistic provision” into the financial statements which would have the effect of spreading profit over the life of the policy.

64. The development of the third SORP commenced in 1993, but progress was slow and it was eventually released in 1998. The key objective of the SORP was to secure an appropriate treatment and disclosure of investment returns. It set out its principal objectives as being:

“to set out recommended accounting practice for the UK insurance business within the framework of the Companies Act 1985 in order to narrow the range of accounting practices and thereby enhance the usefulness of published accounting information; and

to provide guidance on certain [provisions] of the CA85 relating to the financial statements of insurance undertakings where the wording of these provisions requires clarification, or is insufficient in itself to ensure a uniform interpretation of the requirements, or would result in an inappropriate diversity of accounting practice.”

Accounts were now intended to reflect a smoothed return through the profit and loss account with the appropriate transfer to or from reserves so as to reflect reconciliation to actual investment returns achieved during the year. This disclosure was intended to lead to greater transparency and to relate distributed smoothed returns to actual earned returns. The third issue SORP of December 1998 was approved by the ASB. The ABI was approved for the purposes of issuing recognised SORPs containing recommendations on accounting for insurance business including accounting for investments.

65. In November 2003, the ABI released its fourth SORP designed to give effect to the differing influences of general accounting practice, the requirements of schedule 9A of the Companies Act 85 and detailed regulatory requirements. The SORP set out areas in which insurance accounting did not align with ‘general purpose’ accounting practice. These areas included:

- § the deferral of acquisition costs as assets;
- § the inclusion of both members’ equity interests and liabilities in the fund for future appropriations;
- § the measurement of provisions for liabilities to policyholders on a regulatory, solvency basis rather than at the best estimate of the expenditure required to settle them; and
- § the measurement of such liabilities using discount rates based on asset yields, which was inconsistent with certain prescribed accounting standards (FRS 12, 17 and 19).

66. With the exception of the above, the ABI have indicated that the SORP does not appear to conflict with accounting practice or standards. The key developments of relevance to the inquiry contained in this SORP are: the definition of financial reinsurance as opposed to reinsurance, and the requirement that long-term business should be valued in accordance with the gross premium method as defined which explicitly excludes any account of terminal bonuses.

67. Professional guidance has been slow in development and inconsistent in results. Existing guidance gives the impression of a struggle to come to terms with statutory and other requirements while the industry has developed a diversity of practices and while the scope of its business has altered beyond the assumptions that obtained at the start of the process. For present purposes, the material issues arise in connection with the treatment of liabilities in this context.

### The International Context

68. The Companies Act 1985 (Insurance Companies Accounts) Regulations 1993<sup>28</sup> implemented the EU insurance accounts directive by introducing a new schedule 9A to the 1985 Act, which substituted for the existing accounting rules. With effect from financial years commencing on or after 23 December 1994, insurance companies have been required to comply with the new schedule 9A to the 1985 Act in the preparation of their financial statements. The new schedule applied to accounts prepared from December 1995 onwards (although Equitable adopted it for its 1994 accounts). It provided a mandatory format for the accounts of insurance companies and limited the flexibility previously available to insurers by removing the disclosure exemptions. This resulted in the financial statements of insurers being required specifically to show a true and fair view. The new format required separate disclosure of the long-term business provision, liabilities and amounts constituting undistributed surplus, either in reserves or in a ‘fund for future appropriations’ (FFA).

69. Schedule 9A required an insurance company’s balance sheet to include in its technical provisions a long-term business provision (LTBP) which “shall comprise the actuarially estimated value of the company’s liabilities...including bonuses already declared” (note 21, paragraph 9). Paragraph 43 of schedule 9A states that “the amount of technical provisions must at all times be sufficient to cover liabilities arising out of insurance contracts as far as can reasonable be foreseen.” Paragraph 46 of schedule 9A provides for the LTBP to be computed annually “on the basis of recognised actuarial methods, with due regard to actuarial principles laid down in [the third life directive]”.

70. Article 18 of the third life directive provided that “the amount of technical life-assurance provisions shall be calculated by a sufficiently prudent prospective actuarial valuation, taking into account all future liabilities as determined by the policy conditions for each existing contract, including:

- § all guaranteed benefits, including guaranteed surrender values;
- § bonuses to which policy-holders are already either collectively or individually entitled, however those bonuses are described – vested, declared or allotted;
- § all options available to the policy-holder under the terms of the contract”.

The actuary whose duty it was calculate the LTBP (in accordance with section 46(3) of schedule 9A to the Companies Act 1985) was designated the ‘Reporting Actuary’ under GN7.<sup>29</sup>

### International Accounting Standards

71. Internationally as well as domestically, the development of an acceptable framework of accounting standards for insurance business, both general and long-term, has proved to be an intractable problem that has so far eluded solution. In the international context, a degree of urgency was introduced in March 2002 when the European Parliament approved a Financial Services Action Plan that included a requirement that all EU listed companies must adopt International Accounting Standards Board (IASB) standards for consolidated financial statements from 2005, subject to optional deferment until 2007. But by then there had been a recognised need for standards over many years. The history of attempts by the IASB (and its predecessor, the IASC) to achieve agreement on a statement of principles has been

<sup>28</sup> SI 1993/3264.

<sup>29</sup> Guidance Note 7, ‘The Role of Actuaries in Relation to Financial Statements of Insurers and Insurance Groups writing Long Term Business and their Relationship with Auditors’, issued by the Institute and Faculty of Actuaries.

widely discussed<sup>30</sup>. It is a matter of concern that IASC and IASB attempts at promulgating appropriate standards appear to have been frustrated thus far.

72. The IASB has been engaged on an insurance contracts project since publication of an issues paper in December 1999. Work began on a draft statement of principles (DSOP) in December 2000. The first insurance standard, which is primarily a disclosure standard, is not expected until 2005. Insurance 2, which is intended to deal with accounting methods, is not expected until 2006. While superseded as a statement of the likely approach for the future, the DSOP provided an indication of professional thinking, however qualified, at the time of its issue. It envisaged the recognition of insurance liabilities exclusively in terms of contractual obligations. If the DSOP proposals were resurrected, the development of accepted international accounting principles would not require the recognition in accounting statements of non-contractual interests of policyholders such as might be generated by policyholders' reasonable expectations.

73. Some general accounting guidance was provided in the publication 'Elements of Financial Statements', referred to in the DSOP, a guidance document outlining the conceptual framework for accounts issued by the IASC in 1990. In terms of that guidance, a 'present obligation' was a pre-condition of recognition of a liability.<sup>31</sup>

74. On 31 July 2003 the IASB issued a consultation paper setting out the Board's exposure draft of phase 1 of its project on insurance accounting in part-implementation of its programme of proposals to meet the requirements of the action plan. The phase 1 proposals are an interim step towards the radical reshaping of accounting for insurance business. The announcement attracted considerable opposition to the proposals. An ABI spokesperson alleged that the proposals had not been thought through. The European Commission was said to be pressing the Board to hold urgent talks with the industry. The Geneva Association, representing leading insurers, expressed concern about the proposals. The reactions reflected, or appeared to reflect, fundamental underlying differences of opinion as to the role of insurance accounting in instructing a uniform approach to the preparation and publication of financial statements.

75. It would be inappropriate in a report on Equitable to attempt to provide a comprehensive analysis of the development of accounting standards generally, or even of those that have touched on the accounting treatment of long-term insurance liabilities. But the general picture is clear: domestic and international accounting bodies tasked with the development of appropriate standards have failed to produce binding solutions to many of the problems that have been identified by them and other institutions. To date, and no doubt because of the complex nature of insurance liabilities and the fact that such liabilities are required to be determined by the appointed or reporting actuary, no specific accounting standards have been issued by the appropriate accounting standards setting bodies, domestically or internationally. Rather the insurance regulations have governed these requirements in addition to actuarial guidance issued by that profession to its members.

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<sup>30</sup> See, for example, the report to the Accountancy Task Force of the Geneva Association set out on the Geneva Association web site at [www.genevaassociation.org](http://www.genevaassociation.org) and summarised in a paper by Professor Dickinson in the Journal of Insurance Research and Practice, July 2003, page 50.

<sup>31</sup> Elements of Financial Statements, IASC 1990. It defined a liability as "a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefit." On recognition it said that a liability "should only be recognised in the balance sheet if the "outflow" is probable and the "amount" is reliably measurable". As recognised in the DSOP, this definition identified probability of payment as a factor in recognising liabilities. However, in order for an item to be regarded as a liability, it had first to meet the accounting definition of a liability as a 'present obligation' arising from past events. An item might appear to meet the definition of a liability but it might either not be probable that an outflow will be generated by it, or any such outflow is reliably measurable in which case no value would be recognised in the balance sheet. However these issues arose only once a present obligation had been identified.

**Treatment of the Society's Accrued Terminal Bonus**

76. After the introduction of the Society's new bonus system in 1989, Equitable policyholders received annually an explicit allotment of aggregate uplift in the policy values of their contracts, including terminal bonus in an un-guaranteed form. Declared bonus once allotted was provided for in the Society's long-term business provision, but no provision was made in the Society's liabilities for terminal bonus allotments. Nor was any explicit reserve held in the investment reserve and later the FFA to match the accumulated balance of these allocations. The Society's rationale for this approach was that such allocations were not guaranteed and that the value 'accrued' to a policy could be changed by the Society, and in particular could be reduced to zero, at any time. The main influencing factor, as quoted by the Society in its bonus notices to policyholders, that would justify the Society changing this terminal bonus value on a contractual policy termination, would be market conditions.

77. It is clear, in my view, that the Society followed a sustained and systematic pattern of over-allocation between 1987 and 2000 that resulted in contractual terminations receiving policy payouts in excess of the Society's underlying assets attributable to maturing business throughout this period. For non-contractual or early terminations a market value adjustment was applied on terminal bonus from time to time and at various rates in order to align policies values more closely with the underlying assets that might have been attributable to the policies as the claims arose, but there was no sustained or systematic policy that secured balance as a result of an exercise of this kind. In applying its policies, in the case of contractual terminations, the Society paid out the full value of 'accrued' terminal bonus despite market conditions. For non-contractual terminations either full value or an adjusted lower value for terminal bonus was paid out at those periods when a financial adjustment was in operation. But the adjustment was not particular to the excess in the specific case, and the rates applied left considerable scope for residual over-payment.

78. Terminal bonus payouts were made out of current year surplus with the remainder of the actuarially determined distributable surplus being made available for declared bonus or carried forward. Consequently the value of a claim would represent a policy's aggregate policy value with the guaranteed portion being met by a reduction in the Society's liabilities and the non-guaranteed (terminal bonus) portion being met by a reduction in current year surplus. This method was adopted in both the accounts and the return.

79. The Society's ability to account for terminal bonus in this manner circumvented recognition in any form in either the statutory accounts or the regulatory return of the balance of the accumulated terminal bonus accrued on in-force business and intimated to policyholders. Whether or not the Society was under any obligation to account for the accrued value of such terminal bonus allotments (which gave rise to an off balance sheet exposure) in either its accounts or returns depends on meaning and effect of the various reporting requirements discussed earlier.

80. Nothing in the provisions examined above casts doubt on the regularity of the Society's practice. As noted above, section 46(3) of schedule 9A of the Companies Act 1985 states in relation to liabilities that:

"The computation shall be made annually by a Fellow of the Institute or Faculty of Actuaries on the basis of recognised actuarial methods, with due regard to the actuarial principles laid down in the Council Directive 92/96/EEC."

What those methods and principles were has not been specified: they were left to the profession.

81. There was no relevant accounting standard. The standards that might have been relevant did not include a relevant requirement. Neither SSAP 18 nor its successor FRS 12 required disclosure of accrued terminal bonus. For present purposes it is sufficient to comment on FRS 12. Its objective was to ensure that appropriate recognition criteria and measurement bases were applied, inter alia, to provisions and that sufficient information was disclosed in the notes to financial statements to enable users to understand their nature, timing and amount. The standard defined four fundamental concepts:

- i. Liabilities were defined as obligations of an entity to transfer economic benefit as a result of past transactions or events;
- ii. Provisions were made for liabilities of uncertain timing or amount;
- iii. Legal obligation was defined as an obligation that derived from:
  - a. a contract (through its explicit or implicit terms);
  - b. legislation; or
  - c. other operation of law.
- iv. Constructive obligation was defined as an obligation derived from an entity's actions where:
  - a. by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity had indicated to the parties that it would accept certain responsibilities; and
  - b. as a result, the entity had created a valid expectation on the part of those other parties that it would discharge those responsibilities.

82. The Society was not under a present contractual obligation to pay terminal bonus prior to maturity. On the IASB's approach to constructive obligations, there would be no such obligation at any given reference date to make payment in future. The Society's terminal bonus policy and practice after 1989 had at least some of the characteristics of conduct creating a constructive obligation according to these statements. But there is a feature that negatives a final view to that effect. FRS 12 states:

“a provision should be recognised when:

- š an entity has a present obligation (legal or constructive) as a result of a past event;
- š it is probable that a transfer of economic benefits will be required to settle the obligation; and
- š a realisable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.”

83. In respect of ‘measurement’ the standard states:

“The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date.”

In this regard, the Society had accurate records of value of accrued terminal bonus and policy values (as reflected in their internal office valuation). But that did not represent the value of a present obligation, legal or constructive. One could not conclude that the full value of accrued terminal bonus should have been provided for. Further FRS 12 states:

“The FRS applies to all financial statements that are intended to give a true and fair view in accounting for provisions, contingent liabilities and contingent assets, except those arising in insurance entities from contracts with policy-holders.”

84. It would appear that the basis for this exclusion was that the appointed actuary was required by the 1995 Act to compute the long-term business provision of a life assurance company, on the basis of recognised actuarial methods, with due regard to the actuarial principles laid down by the third life directive. From the examination of the Society's liabilities and from confirmation received by both appointed actuaries in office over this period, no recognition of terminal bonus was made in either the accounts or returns. That reflected the accepted view among actuaries, in GAD and the wider profession.

85. This is an area in which industry and actuarial thought continues to develop. In a technical notice dealing with policyholders' reasonable expectations and terminal bonus, Tillinghast said:

"Actuaries will, ..., need to apply their view of (policyholders) reasonable expectations in assessing the adequacy of the long term liabilities. This raises many questions as to the level of reserves which should be held. For example, if policyholders expect terminal bonuses, should the actuary reserve for accrued terminal bonuses, or is it sufficient to ensure that the investment reserve is sufficient to cover this liability? How should the actuary act if the investment reserve is not sufficient to cover accrued terminal bonuses at current rates? There will need to be considerable discussion between the appointed actuary and the company's board in this difficult and ill-defined area."

86. In the case of Equitable, there are separate issues whether an alternative provision should have been made on a reasonable accounting estimate. It might be contended that at least the Society's current liabilities, which represent liabilities that will crystallise and be paid out in the ensuing twelve months period from the balance sheet date, should possibly have been provided for. But these are more marginal in impact on the Society's affairs.

87. The more fundamental issue is whether the standards and guidance that had been developed and put in place over the period of interest to the inquiry left a gap in accounting standards and actuarial guidance issued by the respective professions to their members in relation to terminal or final bonus that undermined the statutory requirement that accounts should reflect a 'true and fair' financial position. The failure to provide for the recognition of accrued terminal bonus meant that financial statements failed fully to reflect the financial position of the enterprise. It may be that in general the practice of maintaining substantial free assets provided cover for terminal bonus. The use of the terminal or final bonus mechanism to uplift policy values on termination was common throughout the industry. Equitable's approach in and after 1989, as communicated to its members was unique. But the test of an effective system of standards and guidance is its capacity to control the accounting obligations of those who put the system to the test by operating at the extremes of permissible conduct.

### **Conclusions**

88. In my view, the Society was not required by statute, nor by recognised accounting or actuarial principle or practice, to value and to set up reserves for accrued terminal bonus payments that were likely to be made in the future, notwithstanding the accrual of those future benefits in its office valuation.

89. The Society exploited the freedom from disclosure that this afforded not only by withholding publication of the accrued value of rolled-up future terminal bonus intimated to policyholders, but by progressively reducing guaranteed benefits:

- i. By altering the mix of bonus between declared and final elements progressively towards terminal bonus; and
- ii. By changing policy conditions to reduce the scope of contractual benefits and increase the scope for allotting terminal bonus.

The Society's published accounts for regulatory and statutory purposes became progressively less relevant as reflections of the actual conduct of business by the Society.

90. This state of affairs was consistent with recognition of contemporary accounting and actuarial practice. That practice had failed to keep up with industry developments and as a result exposed the investing public to the risks associated with inadequate information about the business to which they entrusted their savings.

**CHAPTER 11: THE EXTERNAL AUDIT OF A LIFE OFFICE**

1. I have explained that it cannot be for an inquiry such as this to enter into the debate on the formulation of appropriate accounting standards. In the same way, it is for the auditing branches of the accounting profession to develop and formulate standards for the performance by auditors of their duties. However, it is appropriate to comment on some of the problems that have arisen from the lack of appropriate standards, especially where, despite compliance with accepted contemporary guidance, financial information describing the experience of Equitable failed fully to disclose the realistic position of the Society, and to ask whether past experience gives particular support to the need for those involved to resolve outstanding issues in the interests of policyholders, and, where relevant, shareholders of life companies. The specific area of interest for present purposes is terminal or final bonus.

2. Without adequate accounting standards, audit must lack an appropriate point of reference in relation to insurance accounts. Policyholders and their advisers, as consumers of accounting information about regulated entities, cannot have a reliable basis on which to reach views on their financial affairs, and in particular on the respective merits of competing providers of products in the insurance market, so long as there remain significant deficiencies in the generally accepted standards that can be assumed to instruct the preparation and, in consequence, the audit of published financial statements.

3. In this chapter, I shall narrate my understanding of the position that obtained generally, but with less emphasis than might have been hoped by some commentators on the final, significant period of Equitable's history. I have not attempted to formulate the scope of Ernst & Young's audit obligations in relation to Equitable's accounts, nor to form or express any view on the firm's own description of those duties. Nor have I sought to form or express any views on Ernst & Young's performance or failure to perform their contractual or general duties of care in the course of audit. To have done so would have been inconsistent with my terms of reference, and it is clear that it could not have been otherwise: the inquiry was not structured so as to allow me to resolve contentious issues of definition of the scope of the firm's duties in contract or duties of care generally in the performance of audit work either in relation to the Society's regulatory or Companies Act financial statements.

4. On 25 July 2003, the Court of Appeal sent for trial the Society's case against Ernst & Young subject to a requirement for amendment that is immaterial for present purposes. The decision identified clearly the difficulty and the complexity of the issues of fact and law that arise in respect of the allegations that have been made by the Society against its former auditors. For the purposes of the striking out application Ernst & Young invited the court to assume that there had been negligence in the performance of their contractual duties. There remained a range of issues, some of which involved considerable novelty, on which there was ample scope for debate. The court has commented on these, and, on the whole, left them for later resolution as the litigation progresses. In addition to the issues debated, negligence will be a live issue at the trial. Any litigant is entitled to have questions that may result in liability for damages focused in adversarial proceedings in which there is an obligation on a proponent to identify and define the allegations to be tested on the evidence, and to have an opportunity to defend his conduct on evidence tendered on his behalf.

5. This inquiry was not set up as an adversarial tribunal. It would have been particularly inappropriate for me to attempt to focus or to resolve issues of negligence or other breach of duty where the views expressed might have related to issues that were properly within the scope of the existing litigation. For the purposes of the inquiry I, not the parties to a dispute, have selected the issues of fact for investigation, having regard to my terms of reference, and I have had the

responsibility of deciding the scope of the investigation of those issues, always with a view to proposing lessons to be learnt for the future rather than resolving disputes over past events.

### **Auditing Standards and Guidance**

6. The present difficulties over accounting standards for insurance entities are inevitably an aspect of the background to any discussion of audit practice. However, despite that and the fact that audit is widely performed by accountants, there are functional distinctions, and the development of practice standards has reflected these. In the United Kingdom and the Republic of Ireland audit standards and guidance have latterly been the responsibility, successively, of the Auditing Practice Committee (APC) and the Auditing Practices Board (APB)<sup>1</sup>. The description of the current position reflects the role of these bodies over time adequately for present purposes. The APB's role is to lead the development of auditing practice with a view to establishing high standards of auditing; meeting the developing needs of users of financial information; and ensuring public confidence in the auditing process by publishing statements of auditing standards (SASs), practice notes (PNs), and bulletins. The APB adopted the standards and guidelines previously prepared by the APC. Old and new SASs have the same status, and the auditing guidelines of the APC have the same status as practice notes. Earlier guidance was published by the Institute of Chartered Accountants in England and Wales (ICAEW) in the form of technical releases.

7. SASs set out either (a) basic principles and essential procedures that auditors are required to comply with in the conduct of any audit of financial statements, except where otherwise stated in the SAS concerned, or (b) additional auditing standards applicable to the conduct of audits of specified types of entity, for example those engaged in specialised industries. The members of the Consultative Committee of Accounting Boards (CCAB) have undertaken to adopt all SASs promulgated by the APB. Failure to comply with the standards set out may lead to disciplinary action by an appropriate regulatory body.

8. Practice notes are designed to assist auditors in applying auditing standards of general application to particular circumstances and industries. Bulletins are designed to provide auditors with timely guidance on new or emerging issues. Practice notes and bulletins are persuasive rather than prescriptive. However they are indicative of good practice and have similar status to the explanatory material in SASs, even though they may have been developed without the full process of consultation and exposure used for SASs.

9. The publications of the APB have reflected the APB's objective of establishing a framework of prescriptive, persuasive and other guidance designed to support and assist auditors in carrying out their function, in a context requiring the exercise of professional judgment at all times. Taken together, these publications are intended to prescribe the basic requirements of proper audit practice, and, where they are applicable, it is intended that they should provide all of those who rely on audited financial statements with a high degree of confidence that audit has been carried out within a well-defined and reliable framework. They provide a measure of due performance of professional duty that carries the authority of the profession as a whole.

10. As with any statements of practice, auditing standards and guidance have to be understood in their wider context. The audit function has recently been described by the APB in these terms:

“The independent audit function is an important aspect of good corporate governance necessary for the maintenance of confidence in the operation of

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<sup>1</sup> The APB was established in 1991 by the Consultative Committee of Accounting Bodies.

business, capital markets and the public sector. It provides reasonable assurance that the published audited financial reports are free from material misstatements and are in accordance with legislation and relevant accounting standards. Auditors' reports thus add credibility to financial information prepared and published by directors or officers. A by-product arises from constructive observations made by auditors to directors and offices based on matters which have come to the auditors' attention in the course of the audit."

This statement was issued in 2001, but it expresses views that have held good for many years. It draws attention to two particular aspects of the audit process that have central importance in relation to comment that may be made on audit in the present context: conformity with legislation, and conformity with relevant accounting standards. The claim that the audit function is necessary for the maintenance of confidence carries with it a responsibility to the public: to ensure that published standards and guidance are available where they are required. That responsibility is incumbent on the accounting professions as a whole. Protracted failure to develop necessary professional rules and practices on which the consumer of audited financial statements could rely would be a ground for serious criticism of the responsible bodies in the context of audit as in the context of accounting standards.

11. The APB has also committed itself to supporting the International Accounting Standards Committee (IASC) in its aim of improving the worldwide harmonisation of auditing practices, and formulating SASs with due regard to international developments, in particular the international auditing standards (IASs) issued by the International Auditing Practices Committee of the International Federation of Accountants (IFAC). The aim of the IFAC is improving the harmonisation of auditing practices throughout the world. In the absence of relevant IASs published by the IASB, the APB retains its domestic responsibilities for the promulgation of local standards within the APB's objectives.

#### Developments in Insurance Auditing

12. I have described in the last chapter the current position in relation to accounting standards for insurance entities. There are no relevant authoritative statements in relation to realistic accounting for future payments of terminal or final bonus. The audit function has, at least to some degree, been frustrated by the persistent failure to promulgate acceptable accounting standards for the industry. As discussed more fully elsewhere, I have concluded that the regulatory structure for insurance company accounting progressively lost touch with the reality of life business as it developed in the 1980s and 1990s. In my view, the auditor of a long-term insurance business has operated, over much of the period with which this inquiry has been concerned, within a flawed regulatory environment without specific guidance on fundamental accounting issues from the responsible professional bodies. This has had a bearing on all published financial statements. I shall comment on the general guidance available and the extent to which it was relevant to the performance of audit. But first, it is necessary to comment on the development of the regulatory framework so far as it bore on the scope of audit.

13. In the late 1960s and early 1970s there was extensive discussion of proposals for amendment of insurance company legislation and regulation. Among the more controversial issues were the approach to valuation of long-term liabilities, and the interaction of the roles of actuaries and auditors. The most significant issue that arose in connection with liabilities related to the practice of actuaries of including over-prudent margins in liability valuations, inflating the liabilities as a result and depressing distributable surplus. Some auditors took the view that this practice undermined the possibility that the accounts could show a true and fair view of the insurer's state of affairs, and qualified, or threatened to qualify, their reports to members accordingly. By the end of 1971, the approach to the audit of insurance accounts generally was a live issue. There was dissatisfaction in the industry with the then current requirement that the auditor should express a view on the true and

fair presentation of accounts that contained long-term business provisions that the industry, and the actuarial bodies, contended the auditor was not competent to assess. Possible solutions included an approved list of auditors, special qualifications for appointment as auditor of an insurance company, and participation in regulation by the British Insurance Association (BIA).

14. Most of the proposals were rejected summarily. On 18 January 1972, the chairman of the BIA wrote to the Secretary of State stating that the BIA could not undertake a supervisory function, or share the DTI's responsibility for supervision. No one thought insurance business special enough to justify specific audit qualifications. The idea of an approved list of auditors was rejected as impractical by the ICAEW on 25 June 1971, and again in discussions between regulators and representatives of the accounting bodies, including the then well-known and authoritative Sir Ronald Leach, in January 1972.

15. Among a range of specific topics discussed by the chairman of the BIA in his letter was the contribution that auditors could be expected to make in relation to outstanding claims reserves in general business. Except in the case of deliberate understatement, where it was conceded that the auditor had a role, his comments were dismissive. The accounting profession was clearly thought to lack actuarial expertise and therefore to have little to contribute to the authority of the financial statements of insurance entities. It is clear that one might have said the same about many other commercial and industrial enterprises that required audit. It is a measure of attitudes towards the actuarial profession, and of the regard in which it was held at the time, that the comment appears to have attracted no adverse reaction.

16. The issue was taken up in correspondence between DTI and GAD, and in internal discussions within DTI in relation to long-term business<sup>2</sup>. Distinctions between Companies Act accounting and accounting in regulatory returns were not highlighted, and were sometimes ignored. On 2 February 1972 Colin Stewart of GAD wrote to DTI. He expressed the view that technical reserves should be the responsibility of the actuary, and that the auditors should be excluded from having any responsibility for these reserves or the disclosure of margins included in them. On GAD's approach, as expressed by Stewart, the role of the auditor in relation to long-term liabilities should be clearly circumscribed.

17. On 28 February 1972 the Faculty of Actuaries responded to a request for comments on the protection of life policyholders. The Faculty's suggestions included strengthening the actuary's certificate under regulations 5 and 6 of the 1968 accounts and forms regulations, strengthening the resources available to DTI's insurance division and GAD, accelerating the scrutiny procedures, and improving the content of published statistics. Audit was not treated as a feature of importance.

18. On 2 March 1972 the accounting services division of DTI entered the discussion. In relation to audit, the division's view was that there was something to be said for widening the responsibility of auditors. It appears that the accounting profession had resisted the suggestion. The memo stated:

“Under the Accounts and Forms Regulations, insurance companies are required to prepare accounts giving a true and fair view, and in order to report on these matters, auditors should have regard to the technical reserves and, thus, should review the claim frequency and claim settlement analyses. Very likely the auditors already do this in the course of forming their opinion on the true and fair view and ... the Institute is really cavilling about imposing an express obligation on the auditor to report on the matters which enter into the calculation of these particular liabilities.

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<sup>2</sup> See also discussion of the origin of PRE in chapter 13.

This proposal would need detailed study but, presumably the auditor could be required to include in his report a reference to any significant departure from any code of guidance which the Accountancy profession might produce.”

Both extremes of opinion had now been articulated within Government.

19. The Institute of Actuaries then commented. The Institute drew attention to: “a problem which arises in distinguishing between the respective responsibilities of the auditor and actuary in completing certificates to the accounts”:

“Under paragraph 2 (1) of the Regulations it is required that the accounts prepared thereunder should give a true and fair view subject only to the proviso to that Regulation. Since this proviso refers solely to the assets, auditors may feel obliged to concern themselves with the valuation of the liabilities. On the other hand, both in Regulation 2 and in Regulation 7, the certificate required under the Regulation 5 is specifically omitted.

The valuation of the liabilities is of course in the first place the responsibility of the actuary. It is then subject to external supervision by the DTI with the assistance of the GAD with its relevant professional knowledge. It is moreover outside the professional sphere of anyone other than an actuary, so that no auditor can properly be asked to be responsible for, or to supervise, the valuation.

We would accordingly strongly recommend that it should be made clear that just as the “true and fair view” is subject to various provisos – such as the proviso to Regulation 2 (1), or corresponding provisos where accounts are being prepared under the Companies Act – so it should also be subject to the Actuary’s valuation of the liabilities.”

20. The terms of regulation 2(1), so far as they related to insurance companies that were not exclusively carrying on industrial business in the UK, were as follows:

“The accounts of every [insurance] company ...and all statements, certificates and reports annexed thereto ... shall give a true and fair view of the state of affairs of the company as at the end of its financial year and of the profit or loss of the company for the financial year:

Provided that such accounts, statements certificates and reports shall not be deemed not to give such a true and fair view by reason only of the fact that the amount at which any asset of the company has been included in the balance sheet is less than the full value of that asset.”

21. A meeting between officials and the Institute of Actuaries followed on 28 March 1972. The role of the auditor was discussed. The departmental view had moved towards reducing the role of the auditor. On 10 April 1972 Cyril Homewood of DTI<sup>3</sup> circulated a note in these terms:

“I am coming increasingly strongly to the conclusion that the present qualified application to insurance company accounts of the ‘true and fair view’ criterion is the wrong way round. Regulation 2 of the 1968 Regulations requires a true and fair view subject only to the proviso that assets may be included in the balance sheet at less than ‘full’ (undefined) value. By implication liabilities, including prospective and contingent ones, must be shown at a ‘fair’ (= prudent?) value since a true value is not normally determinable. ...

... it never made much sense to insist that there should be no fat in the amounts set aside for liabilities. We were somewhat equivocal on this... It is causing particular difficulties between auditors and actuaries because the latter value liabilities on a basis substantially stronger than the contractual commitments would require.

<sup>3</sup> See also chapter 13, paragraph 20 et seq.

I am not clear whether a true and fair view is to be held to exclude generous provision for uncertain liabilities or if so whether an acceptable standard of generosity could be defined. I suspect that the answer to both questions is No, so that prima facie no specific provision may be necessary to permit such generosity. It is conceivable, however, that different answers should be given for long-term business, where it may be easier to quantify the surplus over contractual commitments, and general business. ...

Thus it seems that our aim should be normal true and fair treatment of assets in insurance accounts – subject to any admissibility conditions – together with effective freedom to provide generously for liabilities in both long term and general business. ...”

22. His view was not accepted without argument. A colleague responded that he was not in favour of relaxing the true and fair standard in relation to liabilities on the ground that an unqualified opportunity to inflate liability values could be used to mask the true picture of the office’s claims experience. Although the contemporary records do not deal with the point, I understand that there was in contemporary practice ample justification for the approach to assets. Actuaries frequently adopted the lower of market value and a valuation based on future maintainable dividend yield in financial statements, resulting in the amount included being ‘less than the full value of the asset’. The liabilities issue was independent of that practice.

23. Homewood returned to the discussion on 21 April. In relation to the long-term fund he said:

“The conflict between auditors and actuaries is more difficult because it is perfectly possible to calculate an overprovision for with-profits policies as regards the contractual liabilities, although even this involves acceptance of some assumptions which will invariably have been made by the actuary on a conservative basis.

The adoption of an ‘adequacy’ standard of solvency for long term business, possibly topped up to satisfy EEC with an explicit solvency margin, would however substantially reduce the disputed area. If there is still likely to be conflict... we may have to invent a proviso to the true and fair view requirement which removes the actuary’s valuation of the liabilities from the scrutiny of the auditor.

Since we are also contemplating that the actuary would record his satisfaction with the adequacy and suitability of the assets allocated to the long term fund, possibly the auditor should be required to accept this also without question. ...”

24. On 24 April 1972 Stewart wrote to DTI. The letter set out the GAD view at the time:

“... I was alarmed to see ... that the central issue had been lost sight of, namely the conflict between actuaries and auditors on the life liabilities. ...

There is no easy answer to this: Apart from investment-linked policies where the return on the policy is constrained by the terms of the policy, the usual purpose of valuation of a life fund is two-fold. It will ensure the solvency of the non-profit business and arrange for the emergence of surplus at a particular rate in the case of with-profit business. But the amount of this surplus in any year, and its distribution between policyholders, is at the discretion of the directors of the company. In exercising this discretion they traditionally, indeed necessarily, take the advice of the actuary whose calculations will give them the necessary basis for their decision.

It is difficult to see the purpose, in these circumstances, of an attempt to provide an auditor's certificate that the amount in the life fund presents a true and fair view of a discretionary figure."

He then sketched out two possible approaches. The first was essentially the method generally employed in continental Europe, while the other was to:

"... (ii) Leave the directors their present discretion, in the exercise of which they have no alternative but to take actuarial advice. The life fund's adequacy will be covered by the actuary's Regulation 5 certificate and should be specifically excluded from the auditor's certificate. This is the solution proposed by the actuarial bodies and we support it.

Apart from the fact that auditors are not properly equipped to comment critically on what an actuary has done ... the Government Actuary's Department is properly equipped for this purpose and obtains in the statutory returns the information which enables it to carry out this task. The present obligation imposed upon the auditors (unwittingly?) in relation to the long-term liabilities is one that they cannot in practice carry out but, in so far as it is possible to put a meaning on this obligation, it is one which my colleagues and I can and do carry out in our scrutiny of the statutory returns."

He made observations about the use of asset valuation techniques to allow an orderly emergence of surplus over the years.

25. On 26 April DTI circulated an amended paper setting out the current proposals. The Institute of Actuaries had at first agreed with reluctance and then refused to prepare a note on the conflict between actuaries and accountants on the practice of holding un-quantified free reserves in the long-term funds. It was agreed that so long as the DTI did not take exception to accounts carrying a qualified audit report relating to the long-term fund, actuaries would not complain. And there the matter appeared to rest. The 1969 regulations were not amended to add a further proviso to regulation 2(1). There was no separate provision. The valuation of assets was dealt with in detail in 1974<sup>4</sup>. Freedom to vary investment valuation was restricted. But liabilities were left untouched.

26. There was some further activity on the sidelines. The *Accountant* dated 11 May 1972 published the text of the representations made by the ICAEW to DTI in June 1971 in which, inter alia, they sought guidelines on the proper conduct of certain aspects of insurance companies' audits. This attracted a response from Stewart in a letter to Homewood on 23 May. It is sufficient to note his comment that:

"'Guidelines' are not required in life assurance, of course, because there is actuarial certification and what O'Brien of the LOA<sup>5</sup> calls 'actuarial auditing by GAD'."

27. The role of the auditor was discussed at a meeting held on 5 July 1972 at which the accountancy bodies were represented. It was noted:

"Regarding the role of the auditors in estimations of provisions Mr Ansell [representing the accounting bodies] said that an auditor could only be as good as the person making the estimates. The auditor could not do much more than satisfy himself that the system of estimation was satisfactory. There was room for some education of auditors in this role."

The accounting bodies appeared to accept the position for which the actuaries had been contending: there was no obvious enthusiasm for wider audit responsibilities at that stage.

<sup>4</sup> The Insurance Companies (Valuation of Assets) Regulations 1974, SI 1974/2203.

<sup>5</sup> The Life Office Association.

28. DTI prepared a note of progress to 5 July 1972, summarising emerging conclusions in relation to general business. In relation to auditors it was said:

“Auditors cannot be expected to verify in detail the adequacy of the provisions made for outstanding and prospective claims. They may reasonably be expected to satisfy themselves that the recording systems and the methods used for estimation... are sound and properly operated; some guidance in this and possibly other aspects of the returns may be desirable for auditors with limited experience in auditing insurance accounts.”

29. On 17 August 1972 Stewart circulated proposals for amendment of the primary legislation and regulations in the light of discussions to that point. He covered a range of detailed points. In particular he recommended the amendment of the regulations to provide that the auditor need not be concerned with long-term liabilities that were certified ‘adequate’ by the actuary. That suggestion was not taken up. The more pragmatic solution of ignoring any qualification in the auditor’s report appears to have been adopted.

30. The position from 1968, under paragraph 2(1) of the accounts and forms regulations, had been, therefore, that the 1948 requirement that a true and fair view be presented was modified in relation to assets. It was recognised by the regulators that there should be a qualification of the auditor’s reporting obligations to make it clear that the auditor was not concerned whether the long-term liabilities reflected a true and fair view in reporting on the accounts. The amendments were not introduced, but practice was influenced.

31. In practical terms, the form of the audit report required by the 1968 regulations could accommodate a regulatory derogation in respect of liabilities as it could in relation to assets. Regulation 7(2) required the report to state whether or not, in the auditor’s opinion, the accounts and the statements and reports annexed thereto had been properly prepared in accordance with the provisions of the regulations and whether or not it was reasonable for the persons giving the certificates annexed to the accounts to have arrived at the opinions they contained.

32. The position is illustrated in the Society’s accounts. In the 1966 accounts the report of the auditors included the paragraph:

“In our opinion proper books have been kept by the Society and proper returns received from branches and the accounts, which are in agreement therewith, comply with the Companies Act 1948, in the manner authorised for assurance companies which, under the Act, are not required to show separately reserves and provisions, the movements therein or the market value of investments and on such basis give a true and fair view of the Society’s state of affairs at 31 December 1966, and of the transactions for the year.”

In the 1967 accounts the equivalent paragraph was:

“In our opinion the Society’s balance sheet and revenue accounts have been properly prepared in accordance with the provisions of the Companies Act, 1948, in the manner authorised for assurance companies.”

33. In the 1968 accounts a reference to the Companies Act 1967 was introduced, but the report was otherwise the same. In the 1969 accounts the report was more elaborate, and reflected the terms of the 1968 regulations:

“In our opinion the Society’s balance sheet, revenue account and related statements comply with the Companies Acts 1948 and 1967 in the manner authorised for assurance companies and have been properly prepared in accordance with the provisions of The Insurance Companies (Accounts and Forms) Regulations 1968, applicable to long-term business.

Further, we consider that [the directors] certificates ... on the balance sheet have been properly prepared in accordance with the Regulations and that it

was reasonable for the Society's officers to have arrived at the opinions therein stated."

34. For all practical purposes the position remained the same until the Companies Act 1985 (Insurance Companies Accounts) Regulations 1993 came into effect in respect of financial years commencing on or after 23 December 1994. (The Society adopted the new regulations for 1994 voluntarily.) The accepted view until then was that<sup>6</sup>:

"In respect of the financial statements of a special category company (other than one that is not entitled to benefit from, or that has not taken advantage of, the exemptions from Part I of Schedule 9 to the Act that are set out in Part III of that Schedule), the auditors are *not* required to report whether, in their opinion, the balance sheet and the profit and loss account give a true and fair view both of the state of the company's affairs at the end of the year and of the company's profit or loss for the period. However, they must still report whether, in their opinion, the balance sheet and the profit and loss account have been properly prepared in accordance with the Act [Sec 262]."

#### **Audit Reliance and Dependency on the Work Performed by the Actuary**

35. The limited scope of audit up until 1995 was therefore the result of a policy decision taken in the early 1970s, fully informed by consultation with GAD, the industry and the professions, that secured the actuary's control over the quantification of the long-term fund effectively to the exclusion of challenge by the auditor on true and fair grounds.

36. This was a significant factor, and materially affected attitudes to audit. The surplus in any year, the profit of a general company, was not a function of the current activity of the organisation expressed in terms of accounting principles. The surplus was essentially a function of balance sheet values, a difference between assets at or below market value, substantially if not wholly based on objective criteria, and the actuarially determined liabilities of the office. The liabilities of a life office were typically based on contracts of long duration. Measurement of surplus increased in complexity with projected duration. Significant liabilities accumulated over the duration of contracts, and required valuation based on a number of assumptions, which further complicated both the valuation process, and the measurement of profit. Most of a life office's value was represented on balance sheet by large liabilities matched by underlying investments while the level of value flowing through the income statement was significantly lower. Actuarial control over the emergence of surplus in order to smooth reversionary and terminal bonus allocations, which was seen as core to achieving policyholders' reasonable expectations, was generally held to involve considerable subjective judgment. Overarching considerations of the scope and application of the regulatory solvency rules applicable to life offices, which affected the level and nature of bonus allotments that could be made, added a further layer of complexity.

37. It appears that the accounting and auditing profession, recognising these complexities within life business, did not challenge the paramount importance of the actuary's role in liability valuation. Prior to the early 1990s, auditors relied almost totally on the work of the actuary in computing the long-term business liability. In practice, auditors would perform some high level testing in the form of corroborative inquiry and discussion with the responsible actuary. But the auditor did not verify the quantification of the liabilities as such.

38. Auditing guidance reflected this approach. Technical releases were issued in 1979 (TR 373) and 1984 (TR 568). TR 373 did not require the auditor to express an opinion on the amount of the actuary's valuation but stated that the auditor "should

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<sup>6</sup> Accounting Provisions of the Companies Act 1985: Johnson & Patient, paragraph 13.103, page 332.

understand, as a reasonable person but not as an expert, the objectives which an actuary will have in mind” in performing a financial condition investigation, and should, inter alia, before giving the audit opinion, consult with the actuary in order to obtain reasonable assurance as to the adequacy of the assets to meet the related liabilities. TR 568 gave essentially the same advice to auditors, updated for intervening changes in legislation.

39. In October 1991, the APC issued auditing guidance 311 (AG 311)<sup>7</sup> which had the approval of the DTI. This document was intended to provide guidance on the special factors to be considered in the application of auditing standards to the audit of life insurers. It gave guidance on planning the audit; the premium cycle; the claims cycle; valuation of long-term liabilities; insurance debtors and creditors; and reporting. The guidance, expressing the position at 31 December 1990, stated:

“As a result of the use of disclosure exemptions, the audit objective, as regards the balance on a life fund which contains undisclosed reserves, is to be satisfied that it is at least sufficient to meet liabilities to the policyholders whereas, if disclosure exemptions were not utilised, the audit objective would be to be satisfied that not only was it sufficient but also that it was not demonstrably excessive.”

The auditor was implicitly expected to understand not only the objectives of the actuarial valuation but also something of the basic valuation process.

#### **Audit of the Regulatory Return**

40. AG 311 contained more detailed guidance in relation to the valuation of long-term liabilities than earlier publications. It indicated that the determination of the amount of long-term insurance liabilities for regulatory purposes was the responsibility of the actuary but that there was no corresponding responsibility in relation in relation to financial statements prepared in accordance with the requirements of the Companies Acts. In respect of the latter, the guidance stated:

“However, for the purposes of expressing an opinion on the financial statements in accordance with the Companies Act, the auditor takes full responsibility for expressing an opinion on the financial statements including the amount of the long term fund.”

It added that:

“The [actuarial] principles or the assumptions may have to be varied from time to time to ensure that an adequate standard of providing for liabilities can be maintained in changing conditions and that surpluses can be released equitably as between shareholders and the different classes and generations of policyholders. In any event, the determination of the amount of long term liabilities for the purposes of the Insurance Act will have to satisfy the minimum standards laid down in the 1981 Regulations in ‘making proper provision for all liabilities on prudent assumptions in regard to the relevant factors’.

The guidance set out an analysis of the factors that would require to be taken into account in determining the amount of long-term liabilities, and pointed to the guidance issued by the Institute and Faculty of Actuaries and by GAD.

41. AG 311 therefore clearly acknowledged the difference in approach to the two published financial statements required of a life office. This was a significant development in recognition of duties in relation to the Companies Act accounts. Section 21 of the Insurance Companies Act 1982 (audit of accounts) stated that the

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<sup>7</sup> AG 311: Life Insurers in the United Kingdom, APC October 1991.

“accounts and balance sheet of an insurance company shall be audited in a prescribed manner as determined by the Companies Act.”

42. The guidance contained in AG 311 set out the auditors’ responsibilities in this regard. In outlining the auditor’s responsibilities in terms of regulatory returns to be submitted to the DTI in accordance with section 21, the guidance stated that the auditor’s responsibilities were:

“to state whether, in his opinion, the parts of the Return required to be audited have been properly prepared in accordance with the regulations; and

to state whether, in his opinion, and according to the information and explanations he has received:

§ the directors’ certificate has been properly prepared in accordance with the regulations; and

§ it was reasonable for the persons giving certification to have made the statements therein.”<sup>8</sup>

The standard auditor’s report acknowledged reliance on the certificate of the actuary with respect to mathematical reserves, the required minimum margin, and the identify and value of any implicit items as admitted in accordance with the insurance companies regulations<sup>9</sup>. In this context there was no requirement that a true and fair view be presented.

43. Certification was central to the support of regulatory returns. It is not necessary for present purposes to discuss the development of the relevant requirements over time. Regulation 25 of the Insurance Companies (Accounts and Statements) Regulations 1996<sup>10</sup> provided for a certificate by the appointed actuary relating to the periodical actuarial valuation and compliance with schedule 4 and forms 46 to 49 and 51 to 58 of those regulations. The directors were not required to grant certificates in respect of the schedule and these forms. They were, however, required to grant certificates relating to form 9, the regulatory balance sheet and supporting forms, and forms 20 to 45 relating to the revenue account. The auditors’ report had to cover the regulatory balance sheet and revenue account, but not the areas within the scope of the appointed actuary’s obligations. The balance sheet included the mathematical reserves. But part III, paragraph 10(c) of the schedule only required the auditors to indicate the extent to which they had relied on the actuary’s certificate with respect to the mathematical reserves and required minimum margin of the company. Similarly the auditors’ report had to indicate the extent to which they had relied on the actuary’s certificate in relation to implicit items included in form 9.

44. As at the end of the reference period, therefore, the auditor was entitled to rely on the appointed actuary’s certificate in reporting on the regulatory balance sheet in particular, subject to disclosure of the extent of the reliance. Ernst & Young relied on the appointed actuary’s certificate. In the 2000 returns they stated:

“In giving our opinion we have relied on:

- a) The certificate of the actuary on page 326 with respect to the mathematical reserves and the required minimum margin for long-term business.
- b) The identity and value of implicit items as they have been admitted in accordance with regulation 23(5) of the Insurance Companies Regulations 1994, by virtue of an Order issued under section 68 of the Act on 13 September 2000 and to the extent indicated in note 0902.”

<sup>8</sup> AG 311, para 97.

<sup>9</sup> Currently the Insurance Companies Regulations 1994, regulations 23 (5) and regulations 24 to 26.

<sup>10</sup> SI 1996/943.

The actuary certified, inter alia:

“(ii) that the mathematical reserves as shown in Form 14, together with an amount of £1,500 million (being a part of the excess of the value of admissible assets representing the long term business funds over the amount of those funds shown in Form 14) constitute proper provision at 31 December 2000 for the liabilities (other than liabilities which had fallen due before 31 December 2000) arising under or in connection with contracts for long term business including the increase in those liabilities arising from the distribution of surplus as a result of the investigation as at that date into the financial condition of the long term business; and

(iii) that for the purpose of sub-paragraph (ii) above the liabilities have been assessed in accordance with Part IX of the Insurance Companies Regulations 1994 in the context of assets valued in accordance with Part VIII of those Regulations, as shown in Form 13;”

45. The position therefore was that, for regulatory purposes, the auditor disclosed reliance on the actuary’s certificate that the mathematical reserves were a proper provision for long-term liabilities, taking into account any implicit items.

46. In 2000, the practice of over-distribution was recognised. The actuary’s certificate stated, in addition to the paragraphs quoted above, which were of a standard type:

“(vi) The bonus system operated for accumulating with-profits business identifies the present "policy value" which will be paid where a contractual claim arises. This is a combination of a guaranteed fund and a final bonus amount. The final bonus amount can be altered at any time. At 31/12/2000 total policy values were in excess of the available with-profits assets.

At the date of the signing of these returns equity markets have fallen in value from the year-end levels whilst policy values have continued to rise at the interim final bonus rate of 8% per annum.

Where appropriate the Society has recognised this position in its application of a Financial Adjustment to reduce non-contractual claims amounts.

In view of the projected contractual claims out flow over the next few years, policy values also need to be adjusted to reflect the assets available.

Bonus policy is currently being considered by the Board and these Returns are prepared on the assumption that appropriate action will be taken in the near future.”

This additional material could only have been provided in the actuary’s certificate in terms of paragraph 9 of schedule 6 to the 1996 regulations as material that the appointed actuary considered ‘necessary’ to provide in qualification, amplification or explanation of his certificate. Superficially, and leaving aside the state of the markets, the factors identified would have been relevant to any period from 1987 onwards.

47. AG 311 was superseded, and interim guidance (referred to below in the context of audit for Companies Act purposes) was consolidated, in practice note 20 (PN 20)<sup>11</sup>, issued by the APB in August 1999. This document was prepared in consultation with the FSA and Lloyd’s. PN 20 differed in approach from AG 311, in that it provided guidance on all current auditing standards by demonstrating their application to the specific requirements in the case of an insurer. The document incorporated material from a wide range of pre-existing statements.

48. PN 20 expanded and provided additional guidance to auditors on their responsibilities for reporting on regulatory returns. The auditor had to express:

<sup>11</sup> PN 20: The Audit of Insurers in the United Kingdom.

- “i. an opinion as to whether Forms 9 to 17, 20 to 45 (including supplementary notes thereto) and the statements furnished pursuant to regulations 19 to 21 and 23 have been properly prepared in accordance with the provisions of the 1996 Regulations;
- ii. an opinion on the directors certificate; and
- iii. the extent to which the auditors have relied, in giving their opinion, on the actuary’s certificate with respect to the mathematical reserves and required minimum margin for long-term business and on the identity and value of implicit items included in the Return.”

In addition to these requirements the auditor was required to report by exception on the maintenance of adequate accounting records and other matters specified by section 237 of the Companies Act 1985 (regulation 29).

49. PN 20 described additional procedures required to be carried out by auditors over and above those undertaken by them to report on the financial statements. These were:

- i. the application of the prescribed valuation and admissibility rules to assets and liabilities for which existence, title, etc. had already been considered as a part of the audit of the insurer’s financial statements;
- ii. the sub-division of general business revenue information into accounting classes, business categories and risk groups;
- iii. presentation of the information in the prescribed forms; and
- iv. the specific additional disclosures that fell within the scope of the auditors’ report.

50. Paragraph 16 stated:

“The 1996 Regulations draw a clear distinction between those parts of the Regulatory Return which are required to be referred to in the auditors’ report and those which are not. A significant example of the latter which is of particular importance for a company transacting in long-term business is the abstract of the Appointed Actuary’s valuation report prescribed by Schedule 4 to the 1996 Regulations. The fact that the auditors’ responsibilities do not extend to this part of the Regulatory Return is reinforced by Part III of Schedule 6 which enables the auditors in their report to express reliance on the actuary’s certificate for the mathematical reserves and required minimum margin figures which are derived from Schedule 4. Where auditors avail themselves of the entitlement, they are required to state in their report on the Regulatory Return the extent to which they have relied on the certificate given by the Appointed Actuary. In such circumstances, it is not necessary for the auditor to read the parts of the Return falling outside their report, and their report on the Regulatory Return does not provide assurance on the Appointed Actuary’s assessment of the mathematical reserves in the Regulatory Return, nor on any other matters included in the actuarial certificate.”

51. PN 20 discussed the ‘reasonable expectations of life policyholders’, stating:

“In determining liabilities, the appointed actuary is required to take into account the reasonable expectations of policyholders.”

The section concluded by stating that the primary responsibility for calculating the mathematical reserves and for assessing the reasonable expectations of the policyholders lay with the appointed actuary. However it stated:

“It is possible that, in reviewing the scope and nature of the actuarial investigation in connection with the audit, auditors may become aware of concerns of the appointed actuary in respect of reserving for policyholders’ reasonable expectations. In such circumstances, auditors ought normally to

discuss the matter further with the appointed actuary to establish whether there are any matters, which give rise to a duty to report to the Insurance Directorate.”

52. This was said against a background of change in regulations. The Auditors (Insurance Companies Act 1982) Regulations 1994<sup>12</sup> dealt with the auditor’s duties to communicate with the Secretary of State circumstances that gave the auditor reasonable cause to believe that they were or might be of material significance for determining whether any powers of intervention conferred by the Secretary of State by sections 38 to 45 of the 1982 Act should be exercised. Section 45, provided a catch-all or residual power to impose requirements for protection of policyholders:

- § To protect policyholders and potential policyholders against the risk that the company may not be able to meet its liabilities or, in the case of long-term business, to fulfil the reasonable expectations of policyholders or potential policyholders; or
- § To ensure that the criteria of sound and prudent management are fulfilled with respect to the company.

The auditor now had a more precisely defined obligation to concern himself with liabilities, and with policyholders’ reasonable expectations, among other factors.

53. On this analysis, the guidance set out in PN 20 reflected material developments in professional thinking about the scope of audit of the regulatory financial statements of long-term insurers. But at the end of the day, the auditor was entitled to rely on the appointed actuary’s certificate in relation to the mathematical reserves, subject to disclosure that that had been the basis of the audit report. The treatment of policyholders’ reasonable expectations in the guidance reflects a more fundamental subordination of the auditor’s role to that of the appointed actuary, notwithstanding the 1994 Regulations. Paragraph 38 of the guidance emphasised the primary responsibility of the actuary. The auditor’s role depended on the possibility of becoming aware of concerns that the actuary might have in respect of reserving for policyholders’ reasonable expectations. I have already commented on the difficulties arising from the distinction between recognising and quantifying a liability in this context. But for present purposes it is more material that the auditor’s role was reactive to the appointed actuary’s concerns: it was not defined in terms of independent initiative. That impression was reinforced by the reminder that the appointed actuary had a professional duty in terms of GN1 to report to the DTI insurance directorate in certain circumstances. Ernst & Young’s 2000 audit report annexed to the regulatory return reflected the extent of the audit function at that stage.

### **Audit of the Companies Act Accounts**

54. AG 311 set out the objectives of the auditor in relation to the Companies Act accounts. The focus was on the office’s long-term liabilities. The primary objective was to obtain reasonable assurance that the assets of the long-term fund were not less than the related liabilities. In relation to ascertained surplus, it was an objective to establish whether either its amount or the proportion distributed to shareholders had been materially affected by a change in the valuation approach or assumptions or by exceptional circumstances that might require disclosure in the financial statements, having particular regard to the provisions of paragraph 28(1) of schedule 9 to the Companies Act. The guidance required the auditor to consider any relevant reports made to the directors by the actuary and to discuss with him matters relevant to the valuation of long-term liabilities. In terms of the guidance, the audit approach should be sufficient to ascertain, inter alia: that existing systems procedures and controls generated reliable valuation data consistent with the

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<sup>12</sup> SI 1994/449.

accounting records; that the valuation data was processed and co-ordinated in the valuation and certification process; that the actuary was prepared to give the regulatory certificate and would give similar comfort, if required, with regard to the financial statements for the purposes of the Companies Act; that the extent of disclosures in the financial statements was consistent with a true and fair view; and to show the quantum of free reserves.

55. Auditors were additionally required under this guidance, to establish from reports to the directors by the Actuary, augmented as appropriate by consultation with the Actuary, whether

“... ”

- š the distributions have been made out of the established surplus;
- š any participating policyholders have received not less than their minimum entitlement under the insurer’s statutes; and
- š the transfers to profit and loss account from surplus in which participating policyholders are eligible to participate are not such as to require the company to give notice to the Secretary of State under section 30 of the Insurance Act.”

Accordingly for 1992 and subsequent years there were material developments in the nature and the scope of professional guidance on audit. The guidance relating to liabilities did not expand on the relevant accounting statements and standards. Despite its terms, therefore, the effectiveness of the audit guidance was qualified by the concentration on contractual or guaranteed liabilities inherent in the accounting approach. Further, the emphasis remained on process. In substantial matters the auditor remained dependent on the actuary in relation to liability valuation. In particular, the guidance did not require the auditor to satisfy himself by independent computation or checking of the quantification of the office’s technical provisions.

56. It is necessary to see the position in the context of wider developments over the material period. There were developments in the approach to audit generally from the mid 1980s, accelerating from the early 1990s. From about the beginning of the 1990s there was movement away from the earlier preferred approach which was based on tests of detail looking at source documentation and tracing this into the general ledger, which was ultimately used to prepare the annual accounts. The approach changed towards a top-down risk-based analysis, which focused on high-level industry specific issues used to identify associated risks, which would then have to be dealt with specifically in the audit. At a planning stage the auditor would identify the relevant risks and design appropriate procedures to assess the potential for material error to occur and remain undetected by management. In the case of insurance audit, the changed approach was reflected in the employment of in-house actuaries as part of the audit team. The actuaries’ function was to challenge and test the assumptions used by the actuary in accordance with developing guidance. This resulted in more rigorous testing of the work performed by the actuary. The accounts directive of 19 December 1991 had to be implemented by the adoption of appropriate laws regulations and administrative provisions by 1 January 1994 for application in 1995. In AG311 there was recognition that European requirements would drive change in the scope of and approach to audit. In some respects, AG311 anticipated the changes that would come on implementation of the accounts directive.

57. It is unnecessary for present purposes to note at any length the development of regulations over the early 1990s. The Companies Act 1985 (Insurance Companies Accounts) Regulations 1993; Insurance Companies Regulations 1994, the Insurance Companies (Amendment) Regulations 1994; the Companies (Summary Financial Statement) Regulations 1995; and the Insurance Companies (Accounts and Statements) Regulations 1996 in their several ways changed the regulatory context

in which audit had to operate both in relation to regulatory returns and in relation to Companies Act accounts. Professional guidance in each context was published in response to changing requirements.

58. In Ernst & Young's submission to the inquiry, the position in relation to Companies Act accounts prior to 1995 was described as follows:

"Due to the disclosure exemptions, insurance companies were allowed to understate their assets and report the long-term business fund as a single item in the balance sheet. The audit was therefore not required to consider the amount of policyholder liabilities as a separate item in the balance sheet or to express an opinion in 'true and fair' terms. However, the Companies Act Accounts of insurance companies were required to show a true and fair view subject only to the exemptions available under the Act. The auditor was therefore required to obtain reasonable assurance that the assets of the fund were sufficient to meet the related liabilities and this involved some consideration of the valuation. This practice was reflected in the contemporaneous auditing guidelines."

The submission reflected precisely the guidance in AG311. The position began to change for 1995 and later accounting periods.

59. Audit guidance was developing at the same time. SAS 420<sup>13</sup> and SAS 520<sup>14</sup> dealt with certain key areas in relation to the audit of liability valuation. SAS 420 provided specific guidance on the audit procedures to be carried out when auditing the long-term technical provision. SAS 520 provided additional guidance in this area but went on to deal with and provide guidance on the relationship and responsibilities of the auditor and actuary. In terms of SAS 420, the auditor was required to review the appropriateness of the actuarial assumptions used and the calculation of the provision. SAS 520 stated that the auditor should give consideration to the assumptions and methods used by the actuary and to the reasons for any changes in the assumptions and methods compared with those used in the prior year.

60. Paragraph 17 of SAS 420, on long-term insurance, stated:

"The auditors seek to obtain evidence as to the appropriateness of the long-term technical provision for the purposes of giving a true and fair opinion on the financial statements. Audit procedures may include a review of:

- š The appropriateness of the assumptions used;
- š The controls and procedures to ensure the completeness and integrity of the data; and
- š The calculation of provisions."

61. SAS 420 also included a crucial audit step, which required the auditor to review the analysis of the surplus performed by the client to the extent that it was carried out on an annual basis. This step highlighted any divergence of actual experience from that previously assumed in the actuary's calculation and thus provided the auditor with evidence to assess the reasonableness of the assumptions adopted by the office and its actuary.

62. SAS 520 identified limitations on the scope of the auditor's investigations. Paragraph 4 noted that auditors' education and experience enable them to be knowledgeable about business matters in general, but that they were not expected to have the expertise of a person trained for, or qualified to engage in, the practice of another profession or occupation. Reliance on qualified opinion was inevitable in such circumstances. But there was a realistic recognition of difficulties over

<sup>13</sup> SAS 420: Audit of Accounting Estimates, issued in March 1995.

<sup>14</sup> SAS 520: Using the Work of an Expert, also issued in March 1995.

competence and objectivity where the expert giving the opinion was employed by the entity being audited. Some specific items were highlighted:

- i. Paragraph 13 stated: “If the auditors are concerned about the competence or objectivity of the expert they may discuss their reservations with management or the directors and consider whether sufficient appropriate audit evidence can be obtained.”
- ii. Paragraph 16 stated that in assessing the work of an expert: “The auditor should assess the appropriateness of the expert’s work as audit evidence regarding the financial statement assertions being considered.
- iii. Paragraph 17 developed the point: “This involves assessment of whether the substance of the expert’s findings is properly reflected in the financial statements or supports the financial statement assertions, and consideration of:
  - a. The source of data used;
  - b. The assumptions and methods used;
  - c. When the expert carried out his work;
  - d. The reasons for any changes in assumptions and methods compared with those used in the prior period; and
  - e. The results of the expert’s work in the light of the auditors overall knowledge of the business and the results of other audit procedures.”

63. PN 20 again re-defined the wider context for the auditor’s duties and responsibilities. Paragraph 4 of PN 20 stated:

“In applying the requirements of SAS 520 to technical provisions of an insurer computed, or reported thereon, by an actuary, auditors give particular attention to:

- (a) the formal lines of responsibility defined by the insurer, between the board of directors or managing agent and the actuary;
- (b) the independence of the actuary, his knowledge of the portfolio of business for which provision is being made and his experience of the market in which the insurer operates;
- (c) the role of the actuary whose work they aim to use and the scope of the work undertaken. The actuary’s work may be performed in accordance with regulatory or legal requirements or specific engagement instructions; and
- (d) the approach which the actuary propose to adopt in calculating provisions.”

Paragraph 6 stated:

“In assessing the appropriateness of the actuary’s work as audit evidence, auditors may consider it appropriate to:

- (a) make enquiries regarding any procedures undertaken by the actuary to establish whether the source data used is relevant, sufficient and reliable;
- (b) review or test data used by the actuary; and
- (c) assess the assumptions and computations used including the reasons for any changes in assumptions or computations compared with those used in prior periods.”

64. Paragraph 10 sets out the Companies Act requirements of the actuary to compute the long-term business provision. The statement recognised that usually the long-term business provision in the Companies Act accounts was derived from the mathematical reserves established by the appointed actuary for the purposes of the regulatory return. Auditors were advised to consider the appropriateness of this amount for use in accounts that were required to meet the true and fair criterion.

65. The 1982 Act and the 1996 Regulations did not require the regulatory returns to be drawn up to show a true and fair view. Regulation 5 of the 1996 Regulations required that the return: ‘shall fairly state the information provided on the basis required by these Regulations’. The requirement to consider the interaction of the separate tests had particular relevance in the context of the actuarial practice of including general reserves in the long-term business provision.

66. Until implementation of the insurance accounts directive<sup>15</sup>, the existence of undisclosed reserves in insurers’ accounts implied that insurers did not present a true and fair view in their annual financial statements. The effects of the directive, in summary, were:

- i. Removal of “undisclosed reserves” from the long-term business fund.
- ii. Permitting acquisition costs of new business to be deferred and written off over the life of the policy.
- iii. The requirement to maintain a fund for future appropriations (“FFA”).
- iv. Requirement for a uniform set of accounts.
- v. Specified accounting and valuation rules.
- vi. Accounts to achieve a true and fair view.

The most fundamental impact that the directive had resulted from the final item: the requirement that the accounts are prepared on a “true and fair” basis. The standards and guidance that were in the course of development related to this requirement in particular.

67. Since 1995, the audit of insurance accounts has come closer to the general standard. In their most up-to date expression, the objectives and general purposes of audit are set out in SAS 100<sup>16</sup>. The statement sets out to establish standards and provide guidance on the objective and principles governing the audit of financial statements. The objective is to enable auditors to give an opinion on those financial statements taken as a whole and thereby to provide reasonable assurance that the financial statements give a true and fair view and have been prepared in accordance with relevant accounting and other requirements:

“In undertaking an audit of financial statements auditors should:

- (a) carry out procedures designed to obtain sufficient appropriate audit evidence, in accordance with Auditing Standards contained in SASs, to determine with reasonable confidence whether the financial statements are free of material mis-statements;
- (b) evaluate the overall presentation of the financial statements, in order to ascertain whether they have been prepared in accordance with relevant legislation and accounting standards; and
- (c) issue a report containing a clear expression of their opinion on the financial statements.”

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<sup>15</sup> Council Directive 91/674/EEC.

<sup>16</sup> SAS 100: Auditing Standards and Guidance for Members, issued by the APB, para 1-6 of 3.100. Effective date: periods ending on or after 23 December 1995.

68. In general, financial statements are directed primarily towards the information needs of an entity's shareholders, proprietors or equivalent body of person (in the case of a mutual its with-profits members) prepared with the objective of meeting the true and fair requirement. A degree of imprecision is inevitable in the preparation of all but the simplest of financial statements because of inherent uncertainties and the need to use judgment in making accounting estimates and selecting appropriate accounting policies. Accordingly, financial statements may be prepared in different ways and still present a true and fair view. The user cannot assume that the auditors' opinion is a guarantee as to the future viability of the entity, nor that it provides assurance as to the efficiency or effectiveness with which management has conducted the affairs of the entity. The purpose of an auditor's opinion is to enhance the credibility of the financial statements by providing reasonable assurance from an independent source that they present a true and fair view. The responsibility for preparing and presenting financial statements rests with the directors of that entity. The auditor's responsibility is to express an opinion on the financial statements, not to relieve the directors of any of their responsibilities.

69. The scope of the work required to conduct an audit in accordance with the auditing standards contained in SASs is determined by the auditor. Factors which influence auditors' judgments in this regard include the requirement of, and the guidance contained in, SASs, the requirements of relevant professional bodies, legislating and regulations and the terms of the audit engagement. The auditor gains statutory powers from the Companies Acts. Insurance business is governed by schedule 9A to the Companies Act 1985 which sets out the requirements for the form and content of company accounts.

70. While an audit must be conducted in accordance with the SASs issued by the APC and the APB, the quality of an audit is very much dependant on the auditor having sufficient appropriate knowledge of his client's business, and being able to exercise his professional judgment in areas of subjectivity. And, the success of an audit is also dependant on the robustness of the accounting and other applicable standards in force at a particular time. If there is no accounting standard that requires a particular transaction to be accounted for or treated in a specific manner in the first place, the auditor will have no specific guidance or justification in dealing with complex issues in a manner which may more appropriately support his views even though he has carried out all necessary audit procedures indicated by general guidance.

### **Duty to Report to Third Parties**

71. The auditor has clearly defined obligations to report to regulatory and other authorities. Section 21A of the 1982 Act<sup>17</sup> states that an auditor's professional duties will not be breached if he communicates in good faith to the Treasury or Secretary of State, whether in response to a request from them, any information or opinion on a matter of which the auditors has become aware in his capacity of auditor. The Act permits the auditors' professional body to issue such guidance on matters deemed relevant to disclose.

72. Paragraph 112 of AG 311<sup>18</sup> set out the position at December 1991:

“In exceptional circumstances, where it is in the interests of protecting existing and prospective policyholders that the management of the insurer should not be informed in advance, the auditor should report directly to the DTI. In the case of an insurer carry on long-term business, it may still be

<sup>17</sup> Section 21A, communication by auditor with [Treasury or] Secretary of State, was inserted by the Financial Services Act 1986. Regulations were made under the provision in 1994 (SI 1994/449) and modified as part of implementation of the 'Post-BCCI Directive' in 1996 (SI 1996/1669).

<sup>18</sup> Paragraph 112: Reporting Directly to the DTI, AG 311.

appropriate to discuss the matter with the Actuary. Examples of such circumstances are:

- § where there has been an occurrence which causes the auditor no longer to have confidence in the integrity of the directors or senior management, ...
- § where there has been an occurrence which causes the auditor no longer to have confidence in the competence of the directors or senior management to conduct the business of the insurer in a prudent manner so as to protect the interest of existing and prospective policyholders...”

The guidance went on to state that:

“a direct report should be made where the insurer or, where appropriate, the Actuary will not themselves inform the DTI of a matter, having been advised to do so by the auditor or where they have done so within the period of time specified, or where there is not adequate evidence that the insurer or the Actuary has properly reported the matter in question.”

73. The position has developed. SAS 120<sup>19</sup> provides in paragraph 2

“Auditors should plan and perform their audit procedures, and evaluate and report on the results thereof, recognising that non-compliance by the entity with law or regulations may materially affect the financial statements.”

Paragraph 56, which deals with reporting to third parties, states:

“When the auditors become aware of a suspected or actual non-compliance with the law and regulations which gives rise to a statutory duty to report, they should make a report to the appropriate authority without undue delay.

74. More particularly, SAS 620<sup>20</sup>, which deals with the auditors’ right and duty to report to the regulators, provides (in paragraph 2) that:

“Auditors of regulated entities should bring information of which they have become aware in the ordinary course of performing work undertaken to fulfil their audit responsibilities to the attention of the appropriate regulator without delay when

- (a) they conclude that it is relevant to the regulatory functions having regard to such matters as may be specified in statute or any related regulations; and
- (b) in their opinion there is reasonable cause to believe it is or may be of material significance to the regulator.”

In paragraph 14 the term ‘material significance’ is explained as follows:

“the term material significance requires interpretation in the context of the specific legislation applicable to the regulated entity. A matter or group of matters is normally of material significance to a regulator’s functions when, due either to its nature or its potential financial impact, it is likely of itself to require investigation by the regulator.”

75. PN 20 provides additional guidance to the auditor with respect to his responsibilities under this section in Appendices I and II.<sup>21</sup> Matters likely to be of material significance to the regulator, the insurance directorate of DTI at the time, and therefore give rise to a duty to report, fall under the following categories:

<sup>19</sup> SAS 120: Considerations of law and regulations.

<sup>20</sup> SAS 620: Auditors’ right and duty to report to regulators in the financial sector, issued March 1994.

<sup>21</sup> Appendix I: Criteria for Sound and Prudent Management sets out situations which may be regarded by the audit to constitute a breach of this requirement. Appendix 2: Matters of Material Significance: Insurance Companies provides guidance to the auditor.

- (a) matters that could lead to the withdrawal of the insurance company's authorisation;
- (b) matters indicating a failure to comply with the criteria for sound and prudent management;
- (c) matters indicating that a contravention of any provision of the 1982 Act that is likely to be of material significance;
- (d) matters that indicate that the insurance company's continued functioning is in doubt;
- (e) matters indicating that the insurance company's financial statements or regulatory return have not been properly prepared, leading to the auditors' decision to issue a qualified opinion.

A solvency margin breach indicates that a "deterioration in the solvency position of an insurer may constitute a matter of material significance and so trigger a duty to report".

76. The auditor's independent obligation to report to the regulator could, in appropriate circumstances, involve investigations into the reserving policies and practices of the actuary. But the obstacles in the way of the auditor have at all material times been serious. For example, SAS 620 provides for direct report where the auditor has concluded that circumstances have been identified that are relevant to regulatory functions "having regard to such matters as may be specified in statute or any related regulations"; and to have formed the view that the circumstances are likely of themselves to require investigation by the regulator. The auditor would require to form a view of the scope of the relevant statutory and regulatory requirements in the circumstances, of the relevance of the circumstances to the regulator, and of the probability of the need for investigation by the regulator. The circumstances justifying this approach are likely to be extreme.

77. A difference of opinion over providing for terminal or final bonus in advance of a claim would not fit clearly into the range of guidance provided. In general the emphasis on liabilities, interpreted in accordance with accounting standards and guidelines, would have left this area uncovered.

### **Conclusion**

78. In summary, then, the position remained generally static between 1968 and about 1995. AG 311 saw the beginning of a process of change, but it was only mid-decade that the regulatory framework and the supporting professional guidance had become firm and provided a basis for a more developed approach to insurance audit. Even then the lack of appropriate accounting standards meant that the auditor was deprived of one of the main planks from which to develop the approach to auditing insurance companies accounts.

79. As already stated, it is not within the remit of this inquiry to attempt to formulate the scope of auditors' duties or to identify and comment on issues of negligence or breach of duty. The factors I have identified as relevant to the general position as it developed over the period I have reviewed, and to the discussion of lessons to be learnt for the future, may be irrelevant to, or fail fully to explore matters that would be relevant to, the resolution of disputed issues of breach of duty.

80. The following chapter sets out a review of the factual findings derived from Ernst & Young's audit files relating to the audit of the Society between 1990 and 2000. Statements received from members or employees of Ernst & Young have supplemented the written record. The inquiry's approach to the evidence reflected in

the analysis has been to consider its bearing on other sources of evidence relating to the Society's position over time. It has not been influenced by analysis of the issues raised in the current litigation, and is not intended to imply views on the questions of fact focused in the pleadings in the case against Ernst & Young.

**CHAPTER 12: ERNST & YOUNG'S AUDIT OF THE SOCIETY**

1. The inquiry has had access to, and has reviewed in detail, the audit files maintained by Ernst & Young in relation to the Society from 1990 to 2000. It would be of little value to report in full the terms of the comprehensive analysis that has resulted from that exercise. It has informed the investigation, and together with the regulatory material recovered has been of considerable assistance in confirming the relevance of lines of inquiry that had been identified otherwise. Much of the audit material would show due diligence on the part of the audit team in developing a relevant level of knowledge of the client's activities and financial position so as to enable the responsible members of Ernst & Young to form an opinion and report within the terms of the statutory and regulatory requirements binding on them. However, it would not necessarily inform Ministers of the application of the accumulated knowledge and understanding of audit team members in forming such opinion. In any event one would risk exceeding the scope of the remit if one pursued the topic of the discharge of the firm's duties.

2. The audit material has been of value in providing support for evidence available from other sources. And it has identified certain matters of fact on which the auditors may have received less than full information about the Society's financial position. In addition to the documentary materials, I have obtained statements from a number of individuals associated with Ernst & Young, who were given an opportunity to comment on issues that arose from the analysis of the files. In common with other sources of oral evidence, the statements reflect collateral interests related to current litigation and possible professional disciplinary proceedings. I shall draw on them to the extent that I have been satisfied that they are both reliable and qualify or explain documentary records, or add information to that contained in the records on relevant issues. As I have sought to make clear generally, I do not regard this report as a platform for interested parties of any description to make self-justificatory observations related to issues that arise or may arise in other proceedings. It has been a common representation that I am inhibited from making adverse findings in relation to breach of duty. It might reasonably have been expected that I would be similarly inhibited from comment that might imply that any party had discharged its obligations.

**Annuity Guarantees**

3. It appears appropriate to deal first in this context, as I have generally, with the guarantee annuity issue.

4. Until the year ended 31 December 1993, the audit files did not contain material relating to the annuity guarantee issue, notwithstanding that guarantees and options were topics of general interest. Ernst & Young's audit programmes provided for discussion with the appointed actuary of a checklist of standard topics that included guarantees and options. Audit work reflected an interest in understanding how an insurance client's guarantees arose and how option terms included in contracts might be exercised. The appointed actuary was asked to explain how he brought guarantee liabilities into the mathematical reserves and technical provisions respectively. In relation to these issues, the auditor also had an interest in patterns of policyholder behaviour.

5. Ernst & Young's audit actuary, John Bannon, asked about guarantees in the course of an interview of Ranson early in 1994. Ranson told him that, as a result of a dip in interest rates, some policies with annuity guarantees had been in the money but that they did not present an issue. Ernst & Young retained sample contracts on the audit files. Having reviewed an example of a policy containing an annuity guarantee, auditors were aware in general terms of how the guarantee worked and of the schedules that showed how values built up over time. There is no reliable

evidence whether or not the differential terminal bonus policy was explained at that time.

6. An Ernst & Young actuary reported on discussions with Ranson during the 1994 audit. He was advised that a sustained period of negative fund performance could cause the guarantees contained in certain pension products to erode solvency and create problems for the Society. The point was not expanded on. It is apparent from the records that auditors had no knowledge that annuity guarantees were in the money prior to 1998, apart from the brief period over 1993/4. The Society did not make any provision in either the accounts or returns in this regard. In carrying out audit procedures, including the standard questions on guarantees and options, auditors were not advised of any potential risks or exposures in respect to annuity product guarantees.

7. The audit files for 1996 contained a paper prepared by Headdon and Nash that set out solvency projections for the period 1997 to 1999. The paper was reviewed by auditors. The issues revealed by this paper are dealt with below in relation to solvency. The scenarios discussed included one in which the Society sustained investment returns of negative 3%. The projections did not make provision for annuity guarantees.

8. The issue did not arise again until 1998. In November 1997 Bannon attended a Life Conference in Brighton. He was involved in discussions that reviewed approaches to managing annuity guarantees, including differential terminal bonus. The discussions related to the regulatory return process. But annuity guarantees were already an industry-wide issue at this time. Audit began inquiries relating to the Society's annuity guarantees in the summer of 1998. The initial response from the Society's actuaries was that they were currently reviewing their position but had not come to any firm conclusions. The first substantial discussions took place in November 1998, when Bannon met with Headdon to discuss the matter further. Headdon explained that the Society had been discussing its position with GAD. Bannon noted Headdon's position that, because of the differential terminal bonus policy, the take-up rate on annuity guarantees was very low, of the order of 1% or 2%, with the result that the actual cost to the Society was minimal. However, he told Bannon that the regulator was insisting on very onerous reserving, which was not consistent with actual experience. Later, he said that there had been discussions over Christmas and early in the New Year, when the regulator told the Society how the liabilities were to be valued.

9. The audit files reveal extensive investigation and discussion of the issues surrounding the accounting treatment of the annuity guarantees. Ernst & Young's risk assessment prepared at planning stage in respect of the 1998 audit identified relevant risks as: (a) that low long-term interest rates would trigger guaranteed annuity rates on with-profit pensions, giving rise to a strain on solvency where guarantee values were in excess of policies' asset shares; and (b) of adverse press publicity arising from the suggestion that affected policyholders might be entitled to the guaranteed rate and anticipated terminal bonus rather than one or the other but not both.

10. The audit strategies memorandum, also prepared at planning stage, noted that the guarantee involved a promise to pay a minimum annuity rate, but that few experts had thought the guarantee would ever have to be honoured. The recent decline in annuity rates, caused by the decline in long-term interest rates since the start of the 1990s and increases in longevity as life-expectancy tables were amended, had resulted in the guarantees having value. The memorandum also disclosed knowledge of the differential terminal bonus practice, and that it had generated much adverse publicity for the Society.

11. A further audit planning document disclosed in greater detail the auditors' understanding of the history and issues relevant to annuity guarantees. The notes recorded:

“Prior to 1988 ELAS offered retirement annuities with options for guaranteed annuity rates. Interest rates are currently at historically low rates and consequently the guaranteed rates have become attractive to pension policyholders who are approaching retirement. The take up rate at present is approximately 2%. The guaranteed rate is only available if policyholders take all of their return as a level single life annuity that pays quarterly in advance, ie, they cannot commute part of their benefits - which many people like to do. In addition, at present, it is advantageous to take 25% commutation and use those funds to acquire a general annuity (annuitants are only taxed on the income element on general annuities).

The GAD has provided guidance to the industry on reserving for GAOs, which effectively requires that companies assume 100% (or something close to it) of policyholders take the option. 100% gross solvency. ELAS has negotiated financial reinsurance with ERC Frankona. ELAS will be able to recover amounts from ERC if more than 25%, by amount, of pension policyholders opt to take the GAO in a year. ELAS will be liable to repay ERC from future margins. It is not envisaged that cash will pass between ELAS and ERC.

Some ELAS policyholders believe that the GAO is in addition to the terminal bonus on the policies, whereas the Society’s view is that, because terminal bonuses are discretionary, policyholders who choose the GAO will have their terminal bonuses reduced - potentially to zero. The Society’s objective is, as far as possible, to make a policyholder’s pay out equal to his/her asset share. The overriding objective being equity between members. An action group of disgruntled members has been organised by Stuart Bayliss of Annuity Direct. ELAS is financing a test-case in the High Court to establish whether the Society’s stance is valid. The Directors have Counsel’s opinion to support their view and are confident that they will be successful in Court. The £1bn exposure noted above assumes that ELAS will win the case.

The GAO issue poses a threat to the Society’s solvency and capability to remain in business in its present form. Much depends on the movement in long-term interest rates and hence the attractiveness of the GAOs to policyholders.”

At the planning stage, therefore, Ernst & Young had a considerable degree of understanding of the annuity guarantee issue, as presented by Equitable. It is not relevant for present purposes to discuss whether the views reflected in the documents were correct.

12. In the review of the regulatory return, auditors noted that the main issue to affect solvency in the year was the annuity guarantee provision of a gross liability of £1.6 billion, less reinsurance of just over £800m, resulting in a net reserve of under £800m. The audit summary review memorandum contained findings relating to the reinsurance contract arranged with Irish European Reinsurance Company Limited (referred to as ERC above) to cover potential guaranteed annuity liabilities. It was noted that:

“The reinsurer provides surplus cover for the costs arising from the exercise of the guarantee annuity rates in respect of Retirement Annuity policies, Individual Pension Plans and Transfer Plans issued before July 1988. If in any calendar year the proportion of terminations due to retirements exercising the guarantee annuity option exceeds 25% of the total retirements in that calendar year, as measured by the guaranteed funds for those polices, the reinsured gross liability is the value of the guaranteed annuity excess of the guaranteed policy funds for that portion of retirements effecting the guaranteed annuity option which is in excess of 25%.”

The note reflected auditors’ understanding that the arrangements had no practical financial effect at 31 December 1998, but that, in the event of a claim, the reinsurance would become a financing arrangement.

13. In considering the appropriate level of accounting provision, auditors had available a paper provided by Headdon which set out a number of possible views using different calculations based on varying assumptions. This showed that:

- i. £50m was the anticipated realistic economic cost of the annuity guarantees;
- ii. £350m was brought out using the same method as in the return, but with a lower take-up rate. There were other related numbers on a range of take-up rates; and
- iii. The Society supported £200m by projections showing that the economic cost would be below that sum using an office model.

Ernst & Young ran the figures through one of their own computer models and although there was a slight discrepancy, it was not significant and they came up with a number that supported £200m. This equated to a take-up rate of approximately 10%, which was considered reasonable given the Society's experience.

14. In the audit closing meeting between auditors and the Society's executives there was wide-ranging and searching discussion of the provision to be made for annuity guarantees in the accounts. The proposal to value the liability at £200m had not been discussed with the audit committee at that stage, and the discussions covered anticipated problems in satisfying the committee of the validity of the provision of £200m.

15. Ernst & Young prepared a summary review memorandum dated 4 May 1999. Much of the material was repetitive of earlier notes. However, it disclosed in summary the nature and the extent of the information that was available on investigation, but that had not figured in earlier years' audits. And it disclosed the background to the decisions that were required and were taken in respect of the statutory accounts. The conclusions in the summary supported the approach adopted in the returns, and the provision of £200m in the accounts.

16. Audit formed the view that the 'true and fair' requirement would not be met by adopting the same value in the accounts for the annuity guarantees as was included in the returns, because:

- i. The actual take up rate at the time was 1-2%, and the cost was minimal, well below that assumed in the returns, which produced a reserve of £1.6 or £1.8 billion;
- ii. Due to the Society's differential terminal bonus policy, the actual annuity guarantee cost would be well below that provided for on the returns basis; and
- iii. At that time the Society's management were very confident that what they were doing was right and in accordance with their powers.

The summary took comfort from the opinions the Society had obtained from counsel, which were reviewed. In addition to these considerations, the audit team consulted their in-house technical department, who confirmed that it would be appropriate for the amounts in the returns and the accounts to differ with a view to meeting the true and fair requirement in the accounts.

17. In relation to reinsurance, auditors noted that it was on the suggestion of the regulator that the Society sought reinsurance so as to reduce the exposure to annuity guarantees. Additionally the net amount required in the returns would be reduced. Auditors confirmed that they had a working knowledge and basic understanding of the reinsurance agreement. They noted that:

- i. The ERC agreement would take effect if the take-up rate were more than 25% in one year;

- ii. The actual take-up rate was approximately 1-2% and so the reinsurance agreement did not impact on the accounts, as the amount provided for was based on an assumed take-up rate of well below 25%; and
- iii. As far as the returns were concerned, the reinsurance did have an impact, because the returns assumed a take up rate exceeding 25%.

18. Auditors did not regard the reinsurance arrangement as being a typical or standard reinsurance agreement, but they had observed a similarly structured agreement elsewhere. It was understood that the agreement was a new type of reinsurance product and not a traditional one. However other reinsurers, in addition to ERC, wrote similar agreements. It was noted that the SORP set out how reinsurance should be dealt with in the accounts, and the treatment differed from that required in the returns.

19. When Ernst & Young signed off on the 1998 Companies Act accounts, the Society had already launched the court case. The auditors had been informed that the Society had sought legal advice on its position, had been reassured that the Society's position was correct and that it was funding the test case to stop future complaints with respect to this matter. When the auditors signed the accounts, it was considered that there was ample support for the view that the Society was entitled to use the differential terminal bonus policy. Accordingly audit considered there to be no contingent liability requiring disclosure in the accounts.

20. In the following year, 1999, Ernst & Young again highlighted guaranteed annuity options as a key area of focus. It was noted that the statutory reserve required for annuity guarantees had weakened the Society's solvency position. Some of the options available to strengthen that position had already been used, for example financial reinsurance. Whilst the financial condition, as projected, appeared to be improving across a range of scenarios, it was noted that there remained a public concern over the Society's ability to cope with severe adverse experience.

21. Ernst & Young reported their audit plan to the audit committee. In respect to annuity guarantees the points noted were:

- i. The Vice-Chancellor had ruled in the Society's favour on 9 September 1999, but had granted Hyman leave to appeal;
- ii. Whilst the representative action continued, there remained some uncertainty regarding the potential outcome. But the first instance decision provided considerable support for the Society's approach;
- iii. In the 1998 annual report, the amount provided in relation to the cost of options was £200m;
- iv. The directors would need to reconsider the level of provisions and associated disclosures in the 1999 annual report and the return following developments in the year;
- v. This area had been of particular interest to the press and had increased speculation over the Society's ability to continue as a mutual. Audit understood that the Society had conducted a review to assess whether other products could give rise to similar adverse coverage and solvency issues;
- vi. Audit would review the approach taken to reserving for annuity guarantee options and would discuss this issue with management including the appointed actuary prior to the year-end; and
- vii. Audit would review and discuss with management the outcome of the product range review and any disclosures and provisions that might be necessary.

22. The expectations were summarised as follows:

“In last year’s financial statements ELAS provided £200m for GAOs liabilities in order to show a true & fair view of the Society’s position. This provision may not be utilised if ELAS can continue to pay for GAO take-up by reducing the associated final bonus and bond yields remain above 3%. The liabilities for GAO policies extend to 2033 so there is considerable range for variation in the valuation of those liabilities.

In the 1998 HMT return ELAS provided £800m for GAO liabilities in accordance with GAD reserving guidance (ie not true & fair). This assumes that options will be taken up on 25% of policies and takes advantage of a reinsurance contract that caps the liabilities of GAOs (non-group) to 25% take up.

The actual take up rate is currently under 2%. This is due to the fact that notwithstanding the question of guarantees the annuities offered are not index linked and are single life and as such are not that attractive.

If bond rates fall to 3% then it is likely that the final bonuses would not cover the cost of the guaranteed annuities. Management has considered the possibility of purchasing a structured financial instrument to eliminate this risk but decided that this was too expensive given the current outlook for future interest rates.

We have yet to examine ELAS’s proposed reserves for 1999 but it seems likely that given the absence of finality in the courts the current reserves will be maintained. Given that short-term interest rates have risen during the year while long term rates are largely unchanged then these reserves would continue to appear to be adequate.”

23. Thereafter, the audit file recorded that the Court of Appeal judgment, in Ernst & Young’s view, came as a surprise to everyone, particularly in light of the strength of the Vice Chancellor’s opinion at first instance. However, the decision required a review of the audit approach. The conclusions recorded were that:

“Since issuing our planning report the decision of the Appeal Court has been announced and we are aware of preparations being made for the House of Lords’ hearing. Until the House of Lords’ decision is known, probably not until late summer, a significant degree of uncertainty still exists in relation to this issue.

The 1998 accounts contained a provision of £200m within the actuarial valuation as a realistically prudent view of the potential future cost of GAO’s.

Employing more severe assumptions (as required for the FSA return) the suggested provision increases to £560m (1998 £800m). This assumes that options will be taken up on 25% of policies and takes advantage of a reinsurance contract that caps the liabilities of GAOs (non-group) to 25% take up.

In preparing the accounts, management have used realistic estimates of the cost rather than adopting a “worst case” scenario or one based on experience to date. The actual take up rate in 1999 has been less than 2%. This can be ascribed to the fact that the guaranteed annuities offered are not index linked and are single life only. A contributory factor to this low rate however may have been policyholders deferring decisions pending the outcome of the court case.

We have examined the Society’s calculations of required reserves for 1999 using “realistically prudent” assumptions. These suggest a provision of £174m (1998: £179m). The reserve established in 1998 of £200m has therefore been retained. This reflects the continuing uncertainty in regard to the final court decision.

If long-term bond rates fall to 3% then it is likely that terminal bonuses will not cover the cost of the guaranteed annuities. Management have considered the possibility of purchasing a structured financial instrument to eliminate this risk but have decided that this is too expensive given the current outlook for future long-term interest rates.

We are aware that management have, with legal counsel, explored a number of strategies, which could be adopted in the event of an adverse Lords' decision. Since these proposals do not result in payouts in excess of asset shares we believe that the maintenance of the existing provision is a reasonable approach at this time."

24. Auditors also noted changes in the approach adopted by the Society since the previous year:

- a. the interest rate assumption had increased by 0.25% to 4.25%;
- b. the assumption that GAOs would be exercised if the income achieved was at least 5% higher than under the open market option had been removed;
- c. the assumption that 25% would be commuted to cash had been removed. This and the previous change were consistent with the contingency plan following the court of appeal decision;
- d. the mortality basis had been strengthened by an additional -1 age rating. This strengthening increased to -2 for older males;
- e. the male retirement annuity pension age had been increased from 60 to 65 in line with experience;
- f. the following table showed a breakdown of the GAO reserves:

(£m)	31.12.1998	31.12.1999
Retirement Annuities	88	57
IPAs	30	37
Transfer Plans	1	1
Group Pensions	60	79
Total	179	174

25. The auditors' position on the appropriate level of provision for 1999 was based on three factors:

- i. The Court of Appeal did not exclude ring-fencing the annuity guarantee policies;
- ii. The Society believed that, whether or not the Court of Appeal's judgment was reversed in the House of Lords, they could still use a compromise scheme to put them back in the same position as if they had the differential terminal bonus policy – the same position as in the Vice Chancellor's judgement effectively; and
- iii. Their lawyers were comfortable it would work.

Hence the auditors considered that there was still no need for a contingent liability because the £200m provision continued properly to provide for the liability. Additionally Ernst & Young noted that it was for the Society to decide whether to disclose a contingent liability, and for them to form an audit opinion thereon.

26. Audit included in the conclusions with respect to statutory solvency:

"The statutory reserve required for GAOs and Pension Transfers has weakened the Society's solvency position. Some of the options available to ELAS in strengthening that position have already been used e.g. financial reinsurance. Whilst the financial condition, as projected, appears to be improving across a

range of scenarios, there remains a public concern over the Society's ability to cope with severe adverse experience.

The Society has entered into a reinsurance policy, which mitigates the extreme impact of the GAD's requirements in regard to the FSA Return."

27. In planning for the audit of the 2000 accounts, the key areas of focus inevitably included the impact of the House of Lords' decision on provisioning for the cost of the annuity guarantees. In reporting to the audit committee on the audit plan, Ernst & Young also identified investment performance and fundamental breach of regulations as key business risks for consideration by them during their work.

28. The auditors commented in addition on the understanding that, as a result of the House of Lords' decision, the Society did not believe that it was financially strong enough to continue in its present form and had therefore had to put itself up for sale. Furthermore they identified the severe deterioration in the Society's financial condition as a significant risk item, and noted that public criticism and litigation with respect to the Society's business practices were issues. The auditors also acknowledged that there was a reasonable possibility that their appointment could be terminated.

29. At planning stage, in reviewing the impact of the annuity guarantees on the Society's solvency, Ernst & Young commented:

"ELAS's historic stance on reserving for these GAOs has been that all policyholders would receive their notional asset share. This effectively meant that the cost of the GAO was funded by reducing the terminal bonus on those policies where the option was exercised.

During 1999 the House of Lords ruled that ELAS would have to pay the GAO in addition to the terminal bonus on the relevant policies. This effectively increased ELAS's technical liabilities by an estimated £1.5bn. On current estimates by the Appointed Actuary (discussed at January audit committee meeting) the Society remains solvent after this increase in liabilities but is unable to fund the new business strain and maintain a commercial bonus rate. As a result the Society has put itself up for sale and subsequently closed to new business."

30. In relation to provisions in the accounts, notes at planning stage included observations that:

- i. As a result of the House of Lords' ruling, the provision for the cost of annuity guarantees would need to be increased significantly from the £200m included in the 1999 accounts;
- ii. Various estimates of the actual cost had been made in the press and estimates differed greatly, depending on the assumptions used;
- iii. The Financial Reporting Review Panel (FRRP) had been asked by two policyholders to review the disclosure and audit of this provision in the 1999 accounts, but had yet to respond to those requests;
- iv. Following the settlement of the appeal the directors would need to reconsider the level and disclosure of the provision required in both the accounts and the FSA return;
- v. Decisions regarding the impact of future premiums to existing GAR policies required to be agreed and communicated by the directors;
- vi. If the House of Lords' decision could be classified as a change in law the increase in the provision could be dealt with as a prior year adjustment;
- vii. If the FRRP ruled that the 1999 accounts were deficient, they might insist on these accounts being corrected and reissued;

- viii. Ernst & Young would review the approach taken to reserving for annuity guarantees in 2000 and were already discussing this issue with management including the appointed actuary;
- ix. Legal opinion was being sought in relation to whether the decision constituted a change in law; and
- x. Ernst & Young were working with management to prepare a response to the FRRP and believed there were strong grounds for insisting that the 1999 annuity guarantee provision was reasonable, based on information available at the time the accounts were approved.

31. In reporting to the audit committee on the audit results, Ernst & Young made a number of comments on the provision for guaranteed annuity rate options. They rehearsed the 1999 position, drawing attention to note 17 to the accounts, and commented on the need to make changes in 2000. They said:

“The disclosure made in 1999 (and 1998) was entirely voluntary and we are not aware of any other life company which made specific disclosure of its GAR liability in the Companies Act accounts. The historic purpose of disclosure was to give information that was comparable to the disclosures made in respect of pension transfers and opt-out liabilities and to indicate that notwithstanding the suggestion that the Society was reneging on its obligations there was a real cost arising and benefit to certain policyholders where the application of the GAR to the sum assured and reversionary bonuses gave a policy value which exceeded the cash fund including terminal bonus.

The 1999 provision was made based on the expected cost arising as a consequence of the Court of Appeal judgement. There have been a number of adverse comments by policyholders regarding the quantum of the amount provided and the wording adopted. Their suggestion being, in substance, that the last year’s accounts should have included a provision that was on a ‘worst case’ basis comparable to the findings of the House of Lords or a contingent liability disclosure indicating the potential cost of a judgement which was more adverse than had been adopted by the Court of Appeal.

The Financial Reporting and Review Panel has not instigated a formal enquiry but issued three letters asking for information relating to the 1999 accounts disclosure and more specifically made enquiries about the wording adopted in Note 17 and the adequacy of disclosure of the contingent liabilities that would crystallise if the House of Lords arrived at a judgement more adverse than the Court of Appeal.”

32. They reported that, as a result of the House of Lords’ decision, the provision for the cost of GARs had to be increased significantly from the £200m included in the 1999 accounts. The Society in conjunction with its actuarial advisers had modelled several different scenarios, having made critical assumptions about:

- § future long term interest rates;
- § future mortality;
- § the propensity of GAR policyholders to purchase in whole, or in part, a single life level annuity with their cash fund at the guaranteed rate; and
- § the level of future contributions to be made by the GAR policyholders.

In addition, they noted that approximately 27,000 individual GAR policyholders and a similar number of group scheme members with GARs had exercised their annuity rights on the basis being offered by the Society prior to the House of Lords’ decision. As a consequence it was now necessary to review the offers made to each policyholder and offer rectification if they would have chosen a GAR annuity, had they been offered it on the basis of the House of Lords’ decision. The report commented that the basis of preparation of the 2000 accounts made no assumption

about the potential beneficial consequences of the Halifax contract. In particular, no assumption had been made about the likelihood of success in capping the GAR liability. Technical provisions had not been reduced to reflect the proposed change in contractual obligations under the GARs, whereby the guarantee was to be replaced by an increase in the terminal (or reversionary) bonus attributable to GAR policyholders.

33. On the basis of these points, it was reported that in the Companies Act accounts a provision of £1.8 billion had been established. The effect had been to put a charge through the technical account of £1.6 billion to increase the total technical provisions to £31.4 billion with a consequential reduction in the fund for future appropriations. The charge for the year, including an additional £200m in respect of the rectification scheme, had been specifically shown on the face of the profit and loss account. Ernst & Young reported that, in arriving at the provision made, the assumptions about mortality and interest rates were consistent with those made for other parts of the actuarial valuation and were consistent with the disclosures made in note 18 to the accounts. They commented on take-up rate experience. Since the House of Lords' decision, the rate had been relatively consistent, indicating that a take up-rate of 55% might be appropriate although the take-up rate in December was 57%. However there was uncertainty as to whether the experience of recent months was representative of policyholder behaviour in the future and accordingly the provision had been set on the assumption of a 60% take up rate. The change to 60% had increased the charge by £300m. Management would review the January take-up rate, once it had been calculated, as a further indication of likely policyholder behaviour. If it indicated experience in excess of 60% the basis of the provision would require reconsideration.

34. It was also reported that the population of GAR policyholders was a discrete and reducing group. There were approximately 215,000 such policyholders at 31 December 2000 of which the majority were not making additional contributions, indicating that they no longer had the net relevant earnings eligible for contributions. The assumption was that with the declining population eligible to make contributions, future contributions would fall by 5% per year. This assumption was previously 20%. If policyholders had restored confidence about future investment performance, contributions could increase but the generally negative publicity was more likely to lead to a fall in future contributions. The rate of decline in policyholders was approximately 6% p.a., but those remaining typically made greater contributions, so the assumptions made some allowance for increased contributions.

35. The actuarial estimate for the rectification scheme was approximately £200 million, which was in addition to in the £1.6 billion charge above. Ernst & Young expressed the view that it was not necessary under FRS 12 to note as a contingent liability the inherent uncertainty in the insurance technical provisions that arose from the judgments that had to be made in arriving at the provision.

36. Revised footnotes had been drafted that indicated the level of the provision and referred to the issues in respect of which assumptions had to be made. There was no specific disclosure about take-up rates or future contribution rates. The draft wording recognised the uncertainty relating to take-up rate and future contributions for which there was limited historical experience. In view of the potential impact on the fund for future appropriations, the draft referred to a fundamental uncertainty that had been reflected in an additional paragraph in the audit report. This form of audit opinion was covered by auditing standard AS 600 which stated:

“Where resolution of an inherent uncertainty could affect the view given by the financial statements to the degree that the auditors conclude that it is to be regarded as fundamental, they include an explanatory paragraph when setting out the basis of their opinion describing the matter giving rise to the fundamental uncertainty and its possible effects on the financial statements.”

**Determination and Allocation of Surplus 1990 - 2000**

37. Ernst & Young's audit files did not disclose notes of review of the Society's analysis of surplus. Audit, in the firm's view, had no role to play in the determination and allocation of surplus. Those were entirely matters for the Society's Board and management to consider and resolve, on the advice of the appointed actuary. The firm regarded the appointed actuary as solely responsible for determining the amount of surplus available for distribution. That view was shared by the appointed actuary who would have taken exception to any one in an audit role interfering.

38. Furthermore the Companies Act accounts did not show surplus. Surplus was disclosed in the regulatory return alone. The extent of audit involvement in this area was limited to discussion with the appointed actuary in order to gain the understanding of the various bonus considerations that audit required in order to understand the liability valuation generally. There was a particular need for understanding because the Society performed its liability valuation on the bonus reserve basis (gross premium method).

39. However, the analysis of surplus, which the client prepared to set out the factors that had given rise to the year's actuarially determined surplus, was an internal matter for management. Review of the analysis was not deemed necessary for the purposes of Ernst & Young expressing a view on the accounts.

40. Additionally, the Society only produced an analysis of surplus some months after the publication of the accounts, and consequently it was not available for review prior to audit signing off the accounts. Ernst & Young did not seek to perform a retrospective review of the prior year's analysis of surplus. If such analysis had been available on time then they would have looked at it. Analysis of surplus was considered by Ernst & Young to be a useful and necessary management tool and would have been looked at in that light. For unit-linked business in particular, an analysis of surplus was a powerful tool. Ernst & Young considered it to have less value in relation to with-profit business. The extent of audit work performed in this general context would have centred around the in-house actuaries' review and assessment of the reasonableness of the valuation assumptions used.

41. The audit files did contain references to bonus. These are noted in the next section.

**Liability Valuation**

42. Ernst & Young's approach to the recognition of liabilities in the context of audit was that audit was concerned with contractual or guaranteed liabilities. Since terminal bonus was not guaranteed, and that was the position stated in the Society's bonus notices, it was not regarded as constituting a liability for Companies Act accounts purposes. They regarded terminal bonus as declared at the point of vesting and not earlier. Accordingly Ernst & Young held the view that there was no justification for requesting the Society to accrue for terminal bonus allocations. Essentially Ernst & Young considered that the terminal bonus mechanism gave the policyholder an indicative value of what their policy might yield in the future, subject to market conditions.

43. Past practice of paying out terminal bonus might result in the policyholder having high expectations of receiving terminal bonus, but these values were unguaranteed and would possibly not be paid out in every instance. On this basis Ernst & Young held the view that there was no justification to accrue for terminal bonus either, as no legal or constructive obligation existed to pay them. Accruing for one year's terminal bonus would not inform policyholders, and would simply result in a shift within the balance sheet. Ernst & Young were aware that some insurance companies had accrued for up to three years' terminal bonus to demonstrate a greater degree of prudence. But these companies were in the minority, and the practice was unusual in the industry.

44. In the course of work on the 1990 accounts, audit reviewed Board papers and minutes. Audit noted that Ranson had stated to the Board:

“The board will recall that the approach being taken to the valuation is rather different this year than in recent years. In summary, the basis for valuing the liabilities is being weakened to reflect the higher yields available on assets as at 1 December 1990. The effect of that weakening will enable bonuses to be declared at 31 December 1989 levels without any transfer from the investment reserve in the Companies Act Accounts.”

Whilst at planning stage, audit had identified that the Society had weakened the liability valuation bases so as to maintain bonus rates in line with those declared in the prior year, and with competitors' rates, in addition to avoiding solvency problems. Audit noted that it had been stated by management that, provided market conditions permitted, the Society would revert back to the old method in the following year. Audit indicated an intention to monitor the situation to ensure that the valuation basis returned to 1989 levels. The audit records also stated that the change in valuation was directly linked to the Society's poor investment returns.

45. In 1990, the Society adopted a valuation method different from that applied previously, which directly impacted on their year-end accounts. The effect of the change was to generate distributable surplus without transfer of credit between the investment reserve (balance sheet) and the long-term revenue account (income statement). In ordinary course this transfer had provided for the recognition of capital appreciation as distributable surplus. In previous years the transfer was from the balance sheet to the income statement and reflected the extent of the Society's dependence on capital appreciation to augment distributable surplus, but also demonstrated that the required capital appreciation was available.

46. Audit acknowledged that this change in practice was largely attributable to economic events of the year with a comparison being drawn to the similar situation experienced by the Society in 1974 when there were negative investment returns. Audit suggested that this change was also attributable to market competition, and reflected the Society's desire to avoid appearing weak. The auditors considered that the change of method was a departure from the Society's "normal prudent approach".

47. This departure from normal practice in the preparing the accounts was considered by audit to be motivated by the Society's need to avoid "adverse publicity". It was noted that in form 40 of the regulatory return "a transfer to reserves of £214m had been made, corresponding to a transfer carried out on the appropriate old basis". In the previous year the comparative 1989 figure had been a transfer from reserves of £317m. The latter basis of presentation agreed with the treatment in the 1989 Accounts. Audit concluded that the form 40 gave a "truer reflection" of events, but they considered there was no basis for "challenging this form of presentation", though it represented both a departure from prior year practice and a difference in presentation between the accounts and regulatory returns.

48. Audit raised with Headdon the need to include in the liability valuation two additional reserves; a closure reserve, and a mismatch reserve. It was noted that Headdon indicated that no such reserves would be provided for; because a closure reserve was only needed where the loadings in premiums were inadequate to meet 'run-off' costs, and mismatching would be catered for in the margin between the net premium and bonus reserve (gross) valuation methods. No notes of audit's vouching of the reasoning or validity of Headdon's points were found. Audit also noted that all contingency reserves, previously held in the liability valuation, were written back in current year.

49. The change of valuation approach released surplus. Audit recorded the significant influence of market competition on the Society's bonus rate decisions for the year. It was noted that the Society had considered not declaring a bonus in the

current year, but had decided against that course due to the potential market impact. The declared bonus rate for 1990 was held at the same level as that declared in 1989.

50. The total bonus allocation for the year resulted in aggregate policy values exceeding the value of the Society's assets at market value. Audit noted and queried management's decision to depart from the previous practice of presenting to the Board an assessment of the 'asset share' position of the Society. Management's response was noted to have been that, due to the poor investment returns of 1990, less emphasis was being placed on the asset share approach. It was not evident from the inquiry's review of the audit files whether audit knew the Society's actual asset share position at year-end or the extent of possible over-allocation made in respect of the year.

51. In the course of the 1991 audit, Ernst & Young again reviewed Board papers and minutes. Documents dated October 1991 revealed that the weak liability valuation remained a topic of discussion for the Board in 1991. The auditors recorded that, in a meeting with them, the appointed actuary had acknowledged the weakening of the liability valuation basis in 1990 through the increase in assumed interest rates. The appointed actuary had, in relation to 1990, indicated to audit that, provided investment performance permitted in 1991, he intended to return back to the stronger interest rate basis of 1989. If this was not possible, then he had stated that both the overall bonus allotment and reversionary bonuses would need to be cut.

52. In notes of a subsequent meeting with audit, it was recorded that the appointed actuary explained the difficulty in reducing the overall bonus allotment (overall roll-up rate) in 1991, "given the reasonable investment performance in the year, when the 1990 rate was maintained despite a very poor investment performance". It was further emphasised that the Society intended to play down the significance of the guaranteed bonus element in bonus literature, since these rates were likely to fall further in subsequent years. The audit partner, Richard Coombes, enquired how final bonuses were provided for. The appointed actuary narrated a technical discounted cash flow explanation. Audit's views on this issue were not recorded.

53. The planning section of the audit file for the 1992 audit contained commentary of audit's views with regard to the year-on-year movements in the actuarial bases. The comments recorded were as follows:

"Due to poor investment performance in 1990 ELAS was forced to increase the discount rate for its liabilities in order to maintain bonus rates.

A yield of around 15% was required in 1991 to enable the bonus rates to be maintained without weakening the solvency position.

In the event a yield of only 13.5% was achieved and the client did not return the valuation to its pre 1990 value but instead originally reduced the discount rate on new money in 1991 but used the same discount rate as for 1990 on premiums received before 1991.

This had the effect of slightly strengthening the valuation on the 1990 basis by some £150m. However this leads to a weak Form 9 position and in view of the significance placed on the strength shown in this form by various analysts it was later decided to reduce the strength of the valuation with all policies being valued on the 1990 basis except for bonds, which were valued on a stronger basis.

The final valuation was some £10m in excess of what it would have been based on the 1990 basis. The final valuation was significantly stronger than the statutory minimum basis and no problems with the DTI are anticipated...

We must carefully review the steps taken in 1992 to strengthen reserves and ensure that managements concerns in remaining competitive do not result in the further weakening of the fund.”

54. During the 1992 audit review of Board papers and minutes, it was noted that, in a paper prepared by Ranson and presented to the Board, the actuary had commented on the following issues:

- i. Ranson had reminded the Board of his intention to strengthen the 1992 liability valuation, as intimated during the previous year when he presented the 1991 liability valuation.
- ii. He indicated that he had reconsidered matters and felt that he had further room to move within the current regulations.
- iii. Accordingly the 1992 valuation was a “little weaker than advised earlier in the year”, which effectively meant that some of what would have been held in the liability was being shown in ‘free assets,’ where Ranson felt they were still essentially being reserved for.

55. Audit also reviewed the paper ‘Valuation and Bonus Declaration’ prepared by Ranson, which showed, inter alia:

- i. Ranson indicated that when considering the declared bonus rate there were certain public relation aspects to be borne in mind, but what was of importance was the overall rollup rate (total allotment) for the year.
- ii. Ranson highlighted in his comments to the Board that the excess over the declared bonus rate was not guaranteed and therefore did not have to be reserved for.
- iii. Ranson recommended that in light of an earned return of 18%, a 10% allotment might be a little too low but he reminded the Board of the need to recoup the over-distribution of 1990.

56. The audit file contained a copy of an insurance technical update, prepared by Tillinghast, which set out the consultants’ views on PRE and terminal bonus, and noted:

“Actuaries will, however, need to apply their view of (policyholders’) reasonable expectations in assessing the adequacy of the long term liabilities. This raises many questions as to the level of reserves which should be held. For example, if policyholders expect terminal bonuses, should the actuary reserve for accrued terminal bonuses, or is it sufficient to ensure that the investment reserve is sufficient to cover this liability?”

How should the actuary act if the investment reserve is not sufficient to cover accrued terminal bonuses at current rates? There will need to be considerable discussion between the appointed actuary and the company's board in this difficult and ill-defined area.”

The file does not disclose whether the discussion paper prompted any consideration or action by audit on the issues presented.

57. Over a series of discussions between audit and the Society’s management regarding the valuation bases, Headdon indicated that the Society might not return to its 1989 basis, which was considered strong in comparison to the market, as this strength gave a weak form 9 position and had attracted attention from brokers. In a meeting with audit, including Ernst & Young’s actuarial support team member, Roger Laker, Ranson indicated that he was happy with the strength of the valuation but was reconsidering the balance between keeping the liability valuation strong and having a weak free asset ratio. Ranson’s views on this were thought to imply that to show significant free assets while having a weak valuation basis was an effective PR stunt.

58. Audit noted that questions had again been asked of management about asset shares:

- i. Why there was no commentary in Board papers on asset shares?
- ii. Would proposed bonus rates bring payouts in line with asset share?
- iii. If not, were the levels of expected maturities going to be significantly higher in the next few years, indicating potential solvency problems?

59. Headdon's replies were noted as follows:

- i. More emphasis was being placed on investment return than on asset share.
- ii. Policy values were higher than asset shares in 1990 (120%) but were coming back in line and it was likely to take 2-3 years to correct, failing any dramatic changes to the markets.
- iii. The ratio of policy values to underlying fund asset was 118% in 1991 reducing to 113% in 1992.

60. The planning section of the audit file for 1993 set out the part Ernst & Young's actuarial audit team would play in the overall audit process. The notes described the position as covering:

- i. reviewing the assumptions underlying the reserve calculations,
- ii. reviewing the audit work performed to ensure no key areas were omitted,
- iii. to ensure that the audit team were not over auditing, and
- iv. discussing the valuation with the actuaries.

These procedures were considered sufficient to give audit overall comfort on the value of the reserves.

61. The file recorded the performance of these procedures. The notes and conclusions of the actuarial team on the regulatory return and more specifically the mathematical reserve were as follows:

- i. Management indicated that a decision had been taken not to strengthen reserves further, due to the adverse publicity that the Society had received in the past regarding its form 9 free asset position;
- ii. The actuarial audit work concurred with the Society's actuaries' opinion that the reserve figure was prepared on a prudent basis. The actuarial partner, Roger Laker, expressed this view.
- iii. In a pre-audit committee meeting, it was observed by the members that the Board and the auditors placed reliance on a combination of the appointed actuary's valuation and the external checks performed by the regulator.

62. Audit recorded the Society's approach to setting bonus mix from a review of the board papers:

"The next stage is to determine how the overall roll-up rate for the year should be split between declared and final bonus ie between guaranteed and non-guaranteed allocation. As the board will recall, our established approach is broadly to relate the level of earnings passed on by means of declared rates to the prevailing level of fixed interest yields. From a high point in the mid 80's we have implemented a steady program of reducing rate so that we have reached a rate of 5% for our main classes of business which corresponds to a return of 8.7% [taking into account the basic accumulation rate of 3.5% guaranteed within the contract.]"

63. The auditors held a meeting with Headdon to discuss declared bonus rates. They noted that terminal bonus rates had been increasing as declared bonus rates

were decreasing. Headdon explained that this had an impact on investment decisions in that less was required to be invested in lower yielding gilts due to policy guarantees being lower.

64. The auditors met with Ranson. His comments on asset shares mismatch were noted as follows:

“... there is a slight mismatch here between the asset shares of older business vs. that of newer business but this is not significant.

... JB enquired about ELAS's with-profits philosophy. RR indicated that ELAS did not have an estate as all earnings were passed on to policyholders and by holding on to some you actually do so to the detriment of some tranche of policyholders.

ELAS try to smooth over a 3-5 year period but try not to get tied down too much here ie they try to keep this decision down to the discretion of the management.

Terminal bonuses are reviewed on a regular basis but they have not been officially changed from the levels announced for some years.”

65. It was noted that the factors considered in the calculation of the bonus level as included within the valuation and bonus declaration paper presented to the Board were:

- i. declared rates;
- ii. valuation results and relative strengths for 1993 vs.1992 and 1989 plus DTI form 9 effects;
- iii. total policy values re growth rate to be declared, and the PR effect this would have on ELAS rankings with competitors.

66. In reviewing the board papers, audit identified the information provided to the Board by management that disclosed the asset share position of the Society at 31 December 1993. The Board were told that total policy values still exceeded underlying assets, with 1993 being regarded as the converse of 1990. It was indicated that an allocation of around 12% when “useable” earnings were around 17%, would restore the position of balance between assets and policy values. The review of an investment committee paper by audit revealed a statement by Ranson that current payouts were generally in excess of underlying assets.

67. At a pre-audit internal planning meeting relating to the 1994 audit, it was recorded that audit discussed the requirement of a ‘true and fair’ view audit opinion which would be come into effect when the Society adopted the insurance SORP early . The fundamental difference from past years was identified as audit’s requirement to obtain a ‘greater understanding’ of the long-term business valuation. This initiated a review of audit procedures so as to identify where additional work would be required.

68. The audit-planning memorandum was modified in relation to the liability valuation. Additions were:

- i. The single most subjective area was the valuation of future liabilities arising out of policies in force.
- ii. This valuation was performed by the actuaries in terms of the rules of their professional society.
- iii. Valuations in the industry generally were based on net premiums, while the Society used a gross premium valuation.
- iv. This method included both terminal and reversionary bonuses.
- v. The Society had been criticised for using too prudent a method of valuing the fund, but it was unlikely that they would change their methods.

In a planning meeting between audit and the Society, Headdon stated that he did not intend changing the valuation strength: rather that the presentation of the basis would change to comply with the new regulations.

69. However audit noted that when the formal paper on the valuation and bonus declaration was presented to the Board by Headdon and Nash on Ranson's behalf, it was stated that:

- i. The overall return on the fund at market value in 1994 was minus 5%.
- ii. The total value of liabilities was around £725m lower than would have been the case had the 1993 valuation basis continued to be appropriate.

In a meeting with audit, Ranson confirmed that the basis was the weakest permissible under the regulations. He maintained that the current valuation was marginally stronger than the previous year's. The reason given for this was that the new regulations required each assumption to contain a margin for adverse deviation, whilst the previous regulations only required the overall aggregate to be prudent. There is no note of an attempt to reconcile this statement with the apparently contradictory statement made by Headdon and Nash earlier to the Board regarding the weakness of the valuation.

70. Audit discussed the weakness of the liability valuation and concluded that they were satisfied, on the basis of the information provided to them, that the valuation was prudent and complied with the new regulations. This conclusion was reached after considering the following factors:

- i. The Society used the weakest possible valuation basis, and it was considered that a regulatory mismatching reserve for resilience testing was not needed.
- ii. Despite using this weak valuation bases, the Society still showed a weak free asset ratio of 3.4% compared to 11% in 1993.
- iii. The Society would be further weakened if there was a sustained period of poor investment performance

71. No matters of significance were noted with respect to bonus. Audit discussed the Society's asset share position at the end of 1994 with Headdon. It was noted that:

- i. Headdon had indicated that, at the end of 1993, policy payments were in line with asset shares (the position being about 101% before allowing for deferred acquisition costs but excluding profits from non-profit business).
- ii. The position at the end of 1994 was about 10-12% adrift.
- iii. Appropriate transfer and surrender penalties were being applied, but contractual claims and maturities were not adjusted to reflect the lower market values.

72. Audit noted that they had reached the following conclusions in response to their enquiry:

- i. This matter should be reviewed at year-end, as it would appear that subject to the Society's smoothing policy, bonus rates would need to be cut.
- ii. If market conditions persisted then year-end free assets would be in the area of £400m compared to the preceding year value of £1.4 billion.

In a further meeting between audit and the Society, Ranson confirmed that policy payouts were in excess of asset shares. The meeting's conclusion was that the sustainability of current bonus rates would very much depend on future investment returns and that the current overpayment of approximately 10% over asset share was clearly not a sustainable position.

73. In preparation for the 1995 audit, Ernst & Young carried out an internal review on the 1994 audit. In respect to the work carried out to support the 'true and fair' opinion given, it was recorded:

- i. The actuaries on the audit team needed to address the additional audit risks faced by giving a 'true and fair' audit opinion.
- ii. Concern was expressed over the apparent lack of challenge carried out by audit in respect of the valuation assumptions.
- iii. The audit engagement partner, Richard Combes, countered this 'challenge' argument by stating that:
  - a. he considered the valuation to be based on reasonable assumptions;
  - b. the Society was a mutual (therefore any valuation mis-statement would only affect the balance between the technical provisions and the fund for future appropriations);
  - c. bonuses were based on 10-year (smoothing) cycles; and
  - d. one needed to accept that the valuation was performed on a prudent basis.

74. In a meeting between audit and Headdon the liability valuation was discussed. Headdon indicated that the interest rates used in the valuation were to be strengthened (by a reduction in rates) as yields were down. In concluding the report on the valuation audit work, audit requested the actuarial team to confirm that the bonus rates and assumptions were those discussed and agreed by them with Headdon.

75. The actuarial summary review memorandum for 1995 identified a disagreement on actuarial assumptions between audit and the Society. This matter was outlined as follows:

"They use what I consider could be an under-prudent assumption with respect to future payments of recurrent single premiums.

They assume, on a policy-by-policy basis, that the premiums continue to be paid at the average of the premiums paid over the three years prior to the valuation. As the recurrent single premiums include a loading for initial expense on the contract it would be more prudent to assume that no more premiums are paid.

They have reviewed this and the effect would be to increase the (non-unit) reserves to £19m from £16m ... if they took a worst-case scenario and they would rather not have to do this as they consider that it is not necessary.

Although I am not happy with this, for the accounts the approach they are taking is not unreasonable and in fact is more realistic than the approach strictly allowable for the DTI returns. For the DTI returns I have expressed my concerns and it is up to the Appointed Actuary to decide. However, I do not think this issue would have a significant impact upon solvency."

76. The audit actuarial summary review memorandum noted communications between DTI and the Society with respect to the 1994 valuation bases used in the regulatory return. It was noted that DTI had queried the Society's general annuity mortality basis used in the valuation. The Society had responded that the basis used was in line with office experience but that, nonetheless, they would be strengthening it for the 1995 valuation. Subsequently in a later 'valuation' meeting between audit and Ranson and Headdon the use of new actuarial tables was discussed. The actuaries confirmed that in the 1995 valuation the new annuity tables would be adopted for annuities only, and that otherwise they would move across to new tables, possibly, later on in 1996.

77. The audit actuarial files included copies of correspondence between the Society and GAD. There were technical queries about asset valuations and mortality. Ranson had written to Chamberlain:

“... I have to say that I find a somewhat similar flavour to your comments about the appropriate mortality bases to be used for annuity business. The GAD's right to seek confirmation that Appointed Actuaries have had due regard to relevant factors in determining their choice of basis is undisputable although, I would hope, generally felt to be unnecessary. Your comments appear to imply a rather different approach, whereby the GAD decides what is a professionally satisfactory choice of basis and then sees how close offices come to that. That carries the unfortunate impression that the GAD feel the only people capable of exercising true professional judgement are themselves.”

78. Included in the Society's bonus declaration discussion paper prepared by Nash and Headdon, and noted by audit, there was consideration of the over-distributions for 1990 and 1994:

“The negative actual return in 1994 has led to another period where allocated earnings have run ahead of the actual position. A natural reaction to a relatively high actual return for 1995 would be to allocate less than the actual earnings, so beginning the process of bringing actual and allocated returns back into line over the current smoothing period.

Experience has normally been smoothed over periods of 3-5 years and that would indicate that the aim should be to eliminate the current margin of allocated over actual earnings over the next 2-3 years.”

79. The audit file contained extracts from the Society's promotional literature entitled 'The Society's approach to transfers and switches from with-profits personal pension contracts'. It explained the effect of smoothing of profits against volatility of the market, the market value adjustment and mentions “underlying assets”:

“Up until 31 December 1993, the accumulated returns allocated were broadly in balance with the accumulated return earned over the various periods of time. During 1994, the Society earned about -4% on its assets but allocated 10% for the year. In other words, earnings for 1994 ran 14% behind allocations. To date in 1995 11% has been earned and policies have accumulated at about 7%, hence earnings have run 4% ahead of allocations. The basis currently used is therefore to deduct 10% of the 31 December 1994 value from the current claim value to reflect the shortfall of earnings in 1994 compensated in part by excess earnings in 1995 to date. This adjustment is therefore intended to bring the value on surrender or transfer broadly in line with the market value of the underlying assets.”

80. Grenham of Ernst & Young held a meeting with Headdon, Loseby and Pielage to discuss the actuarial valuation. The file noted:

“The with-profits business contains a guaranteed bonus rate of 3.5%. They are declaring a total of 4% (the same as for 1994). ELAS are reviewing whether they should remove the guarantee altogether. An MVA is applied on surrender, currently 10% of the value of the policy.”

81. The files for the 1996 audit contained general discussion of valuation issues. The actuaries on the audit engagement team noted their view that, for DTI return purposes, the valuation was to be carried out in accordance with guidance notes GN1 and GN8 and the Insurance Companies Regulations 1994. It was noted that the guidance and regulations did not in terms apply to the mathematical reserves for statutory accounts purposes. But in the absence of any relevant guidance or legislation, it was considered appropriate to use the guidance notes and regulations as a basis for developing assumptions for actuarial items appearing in the accounts (particularly as nearly all offices used DTI mathematical reserves, modified as appropriate, in their accounts). Additionally, it was noted that policyholders were

likely to have different objectives from shareholders. Therefore the appointed actuary was required to take PRE into account in carrying out his valuation.

82. The client service memorandum set out audit's observations on Ernst & Young's responsibility with regard to the audit of the Society's long-term business fund as they understood it at that time:

“As stated in the accounting policies the Appointed Actuary determines the long-term business provision. Consequently, we aim to achieve the following objectives in relation to the amount of the long-term business fund and any distribution of surplus during the year:

- a. to obtain a reasonable assurance that the assets of the long term fund are not less than the related liabilities;
- b. if a surplus in any fund has been ascertained, to establish whether this amount has been materially affected by a change in the valuation approach or assumptions or by exceptional circumstances that may require disclosure in the financial statements; and
- c. to satisfy ourselves that any distribution of surplus made by the insurer complies with sections 29 and 30 of the Insurance Companies Act 1982 and with the Articles of Association.”<sup>1</sup>

83. Audit noted that fund weakness and a low free asset ratio might place pressure on the assumptions used in the liability valuation. This risk would need to be monitored throughout the audit process.

84. Planning for the audit of the 1997 accounts involved review of a paper by Clive Letchford dated 7 April 1997 entitled 'Preparation of accounts for a life office'. The following are extracts from this paper:

“Prior to the new Schedule 9A, accounts had not had to show a true and fair view; in particular, the very prudent approach of the DTI return was followed in the statutory accounts as well. There was no concern that the amounts set aside as reserves were excessive from an accountant's perspective and that the accounts consequently contained hidden reserves.

The basis on which accounts are prepared is frequently known as the Modified Statutory Solvency Basis or 'MSSB.' This is because it uses the figures in the DTI return as its starting point in that the reported profit is based on Actuary's transfer from the long term fund; probably the major difference is that all assets are admissible.”

Audit planning identified the valuation liability as a significant amount. The records do not disclose whether an assessment of inherent risk or control risk was performed.

85. Audit prepared a valuation summary review memorandum. This document was by this date usually prepared by Ernst & Young actuaries and solely reviewed the valuation liability. For 1997 it did not disclose consideration of any of the following:

- i. asset shares;
- ii. policyholders' reasonable expectations;
- iii. guaranteed annuity rates; or
- iv. movement in embedded values during the period.

The audit valuation summary review memorandum stated that it had been necessary to hold a resilience test reserve at 31 December 1997. Audit actuaries had reviewed the calculation of that reserve and were satisfied that it was calculated using appropriate methodology.

<sup>1</sup> These objectives repeated substantially the terms of paragraph 79 of AG 311.

86. In planning for the year-end audit, a meeting was held between Headdon, Bannon and Combes. The actuarial valuation basis was discussed:

“Chris Headdon intends using a stronger valuation basis this year reflecting the removal of the ACT credit. The valuation basis will, for the first time in six or seven years, be stronger than the premium basis. This means that there will be an immediate valuation strain (ie initial actuarial reserves will, all other things being equal, be higher than the recurring single premiums received and the difference will run off over the lifetime of the policy. Chris is looking again at the annuitant mortality. A new table was introduced last year but Chris wants to review the extent to which improvements in mortality are allowed for.”

87. During the actuarial closing meeting Headdon commented to Coombes and Bannon about the resilience reserve:

“For the first time an explicit resilience reserve has been shown. Chris hopes that in future he will be able to maintain a steady valuation basis and vary the explicit resilience reserve as required. He underlined the severity of the test and emphasised that the valuation rates of interest used in 31/12/97 is stronger than the pricing basis which was used up to 1989.”

88. The actuarial audit files contained correspondence between Headdon and the scrutinising actuary<sup>2</sup> at GAD. Headdon wrote, in response to an earlier letter, to confirm that policy values exceeded asset shares:

“You are however, correct in deducing that at 31/12/96 the total face value of policies including accrued final bonus was in excess of the value of the assets attributable to with-profits business. Those assets will include items like the accumulated new business strains and so are higher than a pure share of the Form 9 admissible assets.”

Audit were aware of the fact of the excess, and of the impact of excluding inadmissible assets for regulatory purposes.

89. The files for the 1998 audit did not disclose notes on valuation of liabilities other than in relation to the annuity guarantee issue already noted. The general valuation assumptions were dealt with more prominently in the 1999 audit.

90. At the planning stage for the 1999 audit, Ernst & Young identified two factors which they considered likely to have an impact on the Society's actuarial valuation. These were:

- i. publication of revised mortality tables (CIMR 17) which suggested lighter industry-wide mortality; and
- ii. a low interest rate environment.

Audit indicated that the firm's actuaries would review the reasonableness of the assumptions used in the actuarial valuation and the calculation of the deferred acquisition cost asset. The audit file included recently issued professional guidance with respect to relying on actuarial advice.<sup>3</sup>

91. The audit actuarial summary review memorandum revealed the following summary findings:

- i. The valuation results appeared reasonable and to have been calculated using appropriate valuation methods and assumptions;
- ii. There had been no large changes in the main assumptions, but the basis remained prudent in light of the underlying experience. The investment assumptions had been weakened in line with falling yields. The annuity mortality assumption had been strengthened;

<sup>2</sup> See chapter 15, paragraph 42 for an explanation of this term.

<sup>3</sup> Using the Work of an Actuary with Regard to Insurance Technical Provisions, APB, January 1998.

- iii. There had been no material change in methodology this year, other than the move to Prophet from Beaugal;
- iv. The increase in the Long Term Business Provision was due mainly to the effect of new business in the year and the strengthening of the annuity reserves;
- v. The increase in Linked Liabilities was due to strong unit linked growth during the year and new business; and
- vi. The DAC was lower due to contribution from new business being less than the amortisation of in force business.

The conclusion of the summary memorandum was:

“Based on our review of analytical information provided by Equitable’s Actuarial Department we have gained assurance that the reserves shown have not been materially misstated.”

92. The actuarial audit reviewed changes of the valuation assumptions made for the year in comparison with the previous year. The review highlighted the following factors:

*Interest rates*

There had been a change in the annuity rate of interest, which had increased from last year. This was thought to be consistent with increases in the yields in the underlying fixed interest investments.

*Mortality rates: annuitant mortality*

The review stated:

“We broke the mortality basis analysis into three parts: the current experience, the allowance for future improvements, and the margins in the valuation basis for prudence.

The client has indicated that their current experience is PMA80/PFA80 (C=2010) -2, which was the basis that they used last year. We have questioned this for males, as the charts comparing the client’s experience with this basis show that the client’s experience is lighter than this. This does not initially seem prudent. However the client has explained that most of their policies are last survivor, for which the experience is more closely related to female mortality. The margins for females are more reasonable. A further and larger margin for prudence arises from the fact that the comparison charts exclude CPAs, which make up about 25% of the portfolio, and which tend to experience heavier mortality by about 2 years.

We also considered the allowance for future improvements in mortality. To allow for this the client has used PMA80/PFA80 (C=2010) -3, ie an additional one year negative age rating has been adopted. To test the reasonability of this, we used the most recently published mortality tables, namely PMA92 and PFA92. Using these tables, it is possible to gain an insight into how recent mortality experience compares with expected future mortality experience, allowing for future improvements. We believe that the basis adopted by the client makes sufficient allowance for future improvements to mortality.

[Our only concern is that the comparisons used are based on 100% spouse’s annuity. A more realistic comparison should use 50%, and this shows a greater difference, as the male mortality is more significant.]

The client intends to move to a basis this year, which uses the new tables. The new PROPHET system should facilitate this change.”

93. The actuarial audit findings with respect to the valuation assumption changes were as follows:

- i. The assumptions appeared reasonable for the calculation of the UK long-term business provision, with sufficient margins for prudence remaining.
- ii. Based on the review of the work completed and discussions with the client, the actuaries were satisfied that the valuation results had been calculated using appropriate methods, assumptions and data.
- iii. The changes in the AVP process had been reviewed and they concluded that the new controls in place were adequate to cover all of the risks. In addition, they were satisfied that the new valuation system produced the same results as the old system.
- iv. The valuation methodology appeared consistent with prescribed methods.
- v. The valuation assumptions had been based on the results of experience investigations. The firm's actuaries were satisfied that there were sufficient margins in the basis.

94. Audit's conclusions with respect to the actuarial valuation were noted to have been:

*Revised mortality tables:*

"In view of the change in valuation system the Appointed Actuary decided not to adopt formally the new tables and therefore has continued to use previous tables which are based on heavier mortality than the industry is currently predicting. In order to approximate such lighter mortality predictions management have strengthened mortality assumptions by one year (e.g. the assumption is now that a 55 year old will have the mortality previously assumed for a 54 year old). Our analysis has concluded that this approximation is reasonable in light of the Society's actual experience, the mix of males to females, the number of group cases and the number of compulsory purchase cases in the annuity portfolio."

*Low interest rate environment:*

"The only change to interest rate assumptions has been to the annuity rate of interest which was increased (from 4% to 4.25%) from last year. This is consistent with increases in the yields in the underlying fixed interest investments. This change appears appropriate given market trends and asset matching."

95. The position in relation to the 2000 audit was altogether more complex. It has been less easy to isolate valuation issues from solvency. There was clearly a perception that full recording of every aspect of Ernst & Young's work and thought was required. It had been noted in the 1999 files that the firm believed that it might not be re-appointed. The audit summary review was long and comprehensive.

96. The review noted that there had been regulatory changes affecting unitised with-profits (UWP) reserving and reinvestment rates. The reserving requirements for UWP business had been tightened up by FSA. The change in regulation was intended to make sure that UWP reserves sufficiently reflected policyholders' reasonable expectations with regard to surrender values. This change made the practice of discounting the face value of reserves difficult to justify if there was an expectation that fund adjustments would not apply on surrender.

97. In the light of the change, audit reviewed a range of Equitable literature and reviewed records of discussions between the Society and GAD. The Society did not discount the face value of reserves in the main valuation, but did do so in the resilience test. The Society had discussed this at length with the regulators, who had now agreed with their approach. Therefore, the Society believed that the change in the regulations did not affect them. Further it was noted that the with-profit guide

published in 2000 had stated the Society's policy on non-contractual termination, such as early surrender or transfer. The basis for calculating the surrender or transfer value was not guaranteed. It stated that the Society had, on occasion, found it appropriate to apply an adjustment so as to protect the interests of the remaining with-profits policyholders. Details of the adjustments that have been applied in recent years were set out. Similar statements were identified and recorded by audit in respect of a personal pension plan policy statement. Audit concluded:

"We are satisfied that on the basis of this evidence, the approach of ELAS to the new UWP reserving requirements with regard to policyholder expectations are being met, and in particular that the approach used is appropriate having regard to our understanding of ELAS' ability to impose MVA's at its discretion. However we understand that the OFT is considering ELAS' imposition of a 10% (recently increased to 15%) MVA. And note that no provision has been made for any adverse consequences of the OFT's challenge."

It was noted that the resilience reserves were outside the scope of the work Ernst & Young had been instructed to do in relation to the statutory accounts.

98. The review set out the audit actuaries' understanding of the old and new regulatory rules determining the permissible reinvestment rates, and the calculation of Equitable's rates in accordance with the new requirement.

99. The files disclosed details of Ernst & Young's knowledge of and work relating to a number of specific valuation issues in relation to 2000. The general implications of the annuity guarantees have already been noted. In respect of the valuation of the liabilities, audit's notes contained comments on an apparent confusion over the application of a 5% reduction factor which GAD had allowed generally in the computation of annuity guarantee reserves. It was noted that GAD did not understand how the Society's application of an 85% take-up rate, implying a reduction of 15%, was consistent with the guidance. It was noted that:

- i. The Society argued that the overall accumulating with-profit reserves was not reduced by more than 5%, (although the GAR part of the reserves was), and that this was consistent with DAA 13.
- ii. GAD had stated in a letter of 4 December 2000 that, in their opinion, in the context of GARs being worth 30% more than current annuity rates, it would not be prudent to assume that more than 10% of policyholders would take cash or alternative benefits. This would lead to a minimum take up rate of 90%.
- iii. The Society indicated to GAD that they would use a take up rate of 90% in their reserves calculation.
- iv. In a discussion on the future premium assumption built into the calculations, GAD questioned the prudence of using 20% in the past in the light of 25% experience, noting that Ernst & Young reports contained a realistic assumption of 10%.
- v. The Society stated that they intended to strengthen the basis, and GAD acknowledged that intention.

100. In relation to accumulating with-profits business generally, GAD had queried the strengthening of the basis for personal pensions due to reducing the assumed retirement age from 60 to 55. The Society had explained that this was due to experience as earlier retirements had pulled down the experienced retirement age. GAD had responded that the new valuation regulations indicated that age 50 should be used where cash payment could be secured at that age. The Society responded to say that they couldn't see why. GAD responded by saying that was their current view based on their reading of the new regulations. GAD asked for details of the range of ages at which policyholders could exercise retirement options without penalty, and at what age the GAR benefit could be taken. The Society had responded that the age ranges were between 60 and 75 for retirement annuities, and between

50 and 75 for personal pensions. GAR could be taken between 60 and 75, and did not apply to personal pensions. GAD had thanked the Society for this information.

101. In relation to resilience testing, the files noted further exchanges. GAD had asked what retirement ages had been assumed for the purposes of the resilience test, given the wide time interval over which the Society was exposed to varying investment conditions. The Society responded saying that the ages were as stated above. GAD responded to say they were happy with this answer. GAD had asked what the impact would be of the new resilience test 2 on the Society, and whether consideration had been given to weighting the valuation interest rate by amounts and duration of the assets held. The Society believed that the effect would be a reduction of approximately £300m which was about half of the difference between the old and new test 2. Overall, the reserve would not change – the main reserve would increase by a small amount, and the resilience reserve would fall by a small amount. GAD had also queried the effect of the possible benefit to the Society by using a more sophisticated (and justified) set of hypothecations. The Society replied that the effect would be an approximate £750m reduction in resilience reserve, though the result would be a trade off between this result and the result from the paragraph immediately above.

102. Exchanges between GAD and the Society about the Society's use of a zillmer expenses adjustment were recorded at some length. GAD had queried the ½% p.a. deduction of benefit value that was taken for each year up to the date benefits were taken (which, Ernst & Young noted, operated as an adjustment in respect of un-recouped acquisition expenses). GAD had asked how it was calculated on recurrent single premium (RSP) products, what margins were available from future premiums (or elsewhere) to provide for the charge, and whether it was consistent with PRE to assume that in the case of mass discontinuance the outgoing policyholders suffered a charge in respect of un-recouped acquisition costs. GAD had also asked for any product literature that supported the Society's approach.

103. The Society had replied that there was an explicit 4½% standard charge on premiums and although this has been rebated in the past, there were no guarantees that this practice would continue into the future. The Society also stated that they believed that any charges at discontinuance was consistent with PRE – they supplied a policy booklet, key features document, annual statement of benefits and with-profit guide to emphasise this point. GAD had replied that they were still concerned about the use of a zillmer adjustment on RSP business – they were having difficulty accepting that the liability for accrued benefits could be reduced first by assuming that policyholders would pay future premiums, and secondly by assuming that a 4½% charge would be applied to them. GAD felt that in a closed fund situation it would be unlikely that policyholders would continue to pay additional premiums (unless there was a clear advantage to them – e.g. existence of a GAR) and the 4½% reduction would act as a further deterrent to premiums. GAD also felt that it was not permissible to use either margins within the future profits implicit item or possible changes in regulations as possible sources to recoup the ½% allowance on accumulating with-profits business that the Society had assumed in the resilience scenario. GAD also felt that the ½% allowance was not consistent with regulation 67(3) or 72. GAD had gone on to state that this valuation assumption would not be acceptable in the 2000 returns.

104. The Society had accepted this decision, although making the point that it led to a very prudent overall reserving basis for with-profits business. GAD thanked the Society for the documentation that backed up the "charges and PRE" issue and said "we agree that this would appear to support the Society's assumptions regarding mass discontinuance in the resilience scenario".

105. Audit noted that in the same correspondence, GAD had raised a further issue – why the expense provision for pensions accumulating with-profits business reduces from 2% in the base scenario to ¼% in the resilience scenario. In reply to the expense query, the Society had stated that it was inappropriate to hold

unnecessary margins in expenses and had reduced the assumption closer to the 1999 expenses experience (form 41, line 44, 1999 expenses = £36m c.f. the reserved amount of £74m). The Society went on to say that the 2000 expense assumptions were being reviewed, which was noted by GAD.

106. Finally it was noted that in the correspondence GAD had sought to determine what impact the tightening of the reserving rules on treatment of surrender values would have on the Society. Consistently with the findings already set out, the Society had indicated that, as no reserving basis on surrender was guaranteed, there would be no impact on the reserves due to this change. The GAD thanked the Society for the information.

107. This extensive review of GAD correspondence was not reflected in work or expressions of opinion by audit. Much of it appeared to be included for record purposes, subject only to the comfort audit no doubt drew from GAD's acceptance of the Society's practices, or promises about future practice.

108. The audit summary review memorandum noted that bonus allocations for the first seven months of 2000 had been withheld to allow for additional reserving to provide for the annuity guarantee liability. No guaranteed reversionary bonus for the year had been declared. Instead a non-guaranteed amount equating to 3.3% over the whole year had been added to terminal bonuses.

109. In their report to the Board on the results of the audit, comments were made by audit with respect to bonus and the sale to Halifax. It was noted that:

- i. The Society had offered policyholders whose policies matured during the period when bonuses were suspended a contingent terminal bonus. The bonus offer was predicated on goodwill arising on the sale of the Group exceeding £1 billion.
- ii. As no sale proceeds had been recognised in the accounts for the year ended 31 December 2000, it was not appropriate to accrue the cost of any contingent bonuses.
- iii. As the overall goodwill might not reach the £1 billion threshold, the contingent liability needed only to be recognised in the context of the post balance sheet events disclosure related to the Halifax transaction.

110. In their report to the audit committee on the audit results, audit raised a number of issues relating to the actuarial valuation. They commented that the appointed actuary had the statutory responsibility to maintain the solvency of the Society and to report to the regulators. The Society had not at the date of the report prepared the regulatory return to FSA as at 31 December 2000; it was not due until 30 June 2001. They noted that as part of the audit process they had met with the new appointed actuary and with the chief executive to discuss changes to the key assumptions made in arriving at the actuarial estimate of the technical provisions and the reasonableness of these assumptions.

111. They set out the main assumption changes:

#### *Annuitant Mortality*

The mortality basis for male pension fund annuity business had been strengthened for both non-profit and with-profit business based on experience for the period 1995 to 1999. This showed that experience for males was close to the valuation assumption used last year. Therefore, the basis was strengthened by the -1 age adjustment. As this gave a margin of only 2%, the progress of mortality experience on this business would need to be monitored carefully.

#### *Interest Rates*

Over 2000, the FT gilt indices had reduced at each age and had led to the Society dropping annuity valuation interest rates from 5¼% to 4¾% for post-

1991 annuities, and from 5¾% to 5¼% for pre-1992 annuities. The move in the assumptions was said to be reasonable in the light of the underlying move in the indices, allowing for the different outstanding term of each of the pre-1992 and post-1991 groups of annuities.

#### *Future Expenses*

The closure of the Society to new business had the obvious result that all future expenses incurred by the business would have to be met out of margins present in contracts written prior to closure. Although the ongoing costs of managing the closed fund might reasonably be expected to decrease over time, the Board would need to be satisfied that existing margins were adequate particularly in the immediate future while transition costs were being incurred and ongoing costs were still relatively high. Analysis carried out by the Society's actuarial department following the fund's closure had shown that, excluding £15m of non-recurring expenses incurred in 2000, recurring expenses of £46m were covered by product loadings in excess of £60m. Although this suggested that there was adequate coverage, audit recommended that the appointed actuary monitored this situation on an ongoing basis.

### **Solvency**

112. In the course of the 1990 audit, Ernst & Young reviewed board minutes and papers. The auditors became aware that the Society's regulatory solvency cover ratio had reduced from 5 in 1989 to just under 2 in 1990. They noted that Ranson had indicated that this fall was comparable with other offices and that some commentators might try to take advantage of the apparent weakening of the Society. The auditors noted the terms of a board minute in which Ranson represented to the Board that the Society was in a "strong financial position", but was a little tight in terms of regulatory requirements. They raised some concerns over the level of regulatory solvency brought out by the Society's figures. The "weakness" in the current liability valuation method raised auditors' concerns that there might be a risk of potential solvency problems in the forthcoming year. It was noted that under the Society's former approach to valuation, a transfer from reserves would have been necessary to support bonus.

113. In the course of the 1991 audit, the auditors raised concerns over the low excess margin of solvency, of only £80m, over the required minimum margin. This concern was raised at a supervisory audit file review stage and appeared to have been addressed by a meeting with management. However no evidence of this meeting and of what was discussed was found on file.

114. From their review of board papers, dated October 1991, the auditors confirmed that solvency remained a topic of discussion for the Board in 1991. The appointed actuary, Ranson, had expressed his 'mild discomfort' at the technical weakness on form 9 of the regulatory return. While he acknowledged the need for a mismatch reserve it was noted that it did not appear that he was prepared to raise such a reserve because he had applied for a section 68 order to allow for future profits to be taken into consideration in the form 9. It was noted that Ranson felt confident that he would be successful in his application because he had a good relationship with GAD and DTI and he had "a great deal of confidence" in Michael Pickford, the directing actuary at GAD dealing with the Society.

115. At the time of the 1992 audit, Ernst & Young's records show that they had a view of the external economic environment and its impact on life offices in general across the industry. With this in mind, Bannon sent a memo to McNamara making him aware of the relevant issues facing these offices:

- i. Weak equity markets had placed solvency pressures on life offices, forcing some to sell equity holdings and switch into fixed income

investments. This action further exacerbated the continuing weakness of the equity market.

- ii. Bannon indicated that Equitable should be aware of its maturity profile, as a number of insurance companies were facing a significant increase in expected maturities over the forthcoming years, which could have serious implications for solvency. The counter measure suggested by Bannon to maintain solvency was a reduction in terminal bonus rates. Bannon concluded by saying: “overall I think that Equitable continues to be one of the stronger mutuals”.

116. It was noted that the effect of weakening the valuation as against what had been intended earlier in the year had the effect of providing a form 9 solvency position of similar strength to that of 1990 rather than a weaker one.

117. 1993 was a year of high returns. No matters of significance in relation to solvency were identified for this period in the files.

118. In the course of the 1994 audit, solvency was again an issue. After discussions with Ranson, Grenham of the Ernst & Young’s actuarial team reported to audit that:

- i. While Equitable was a successful company it was financially weak and was vulnerable to a sustained period of poor investment performance.
- ii. Ranson used the weakest possible valuation and even then free reserves only represented 3.4% of liabilities (1993 – 11%).
- iii. He, Grenham, suggested that in such a situation the Society would have to start cutting bonuses quite drastically, and possibly more drastically than many of its competitors due to its lack of free reserves.
- iv. Ranson had acknowledged that while the Society was commercially successful it had little free capital in relation to total assets. He went on to indicate that there would be cuts in terminal bonuses unless equity markets improved.

119. In the audit files for the following year, 1995, there was increased focus on the Society’s level of solvency. The auditors found evidence of this from their review of the board and investment committee minutes. The investment committee had commenced reviewing solvency on a monthly basis, while the Board was presented with quarterly graphical representations indicating the values of:

- i. non-linked liabilities;
- ii. statutory solvency margin; and
- iii. free assets.

120. In their review of the year’s board papers, the auditors became aware of Ranson’s views with regards to demutualisation. It was noted that in a ‘future strategy’ paper for the Board he had expressed the following views:

- i. The Society's finances were considered to be well under control as all costs were within those anticipated in the premium bases;
- ii. There was for all practical purposes, no shortage of capital ie the Society suffered no disadvantage from its mutual status; and
- iii. There were no current problems with meeting statutory solvency requirements.

121. Ernst & Young sent a monthly insurance newsletter to the Society. In October 1995 the letter was entitled ‘Creeping Insolvency’. It raised a number of points. It suggested that non-executive directors of life offices might want to consider the following issues:

- i. Not all the surplus represented by the difference between assets and liabilities would be available as ‘free capital’.

- ii. Part of this surplus would need to meet the cost of terminal bonuses, and the amount would be determined using assets share techniques.
- iii. It was, of course, true that until the terminal bonuses were paid, the relevant funds were available for investment, including investment in new business, but care needed to be taken in matching cash flows, taking into account the maturity profile of the with-profits portfolios.
- iv. The non-executive director might therefore ask the Appointed Actuary to demonstrate the level of free capital after allowing for terminal bonuses and additional capital required to smooth bonuses.
- v. It was quite possible that the resulting free capital could be negative, which would indicate an urgent need to reduce bonus rates and move to a lower risk investment strategy.

122. Headdon responded to Ernst & Young stating:

“I was very interested in the above newsflash on questions a non-executive director of a life office might ask the Appointed Actuary. There was, however, one point, which caused me some concern. That was the suggestion on page 3 that, if the free capital after allowing for terminal bonuses is negative, that indicates an ‘urgent need to reduce bonus rates and move to a lower risk investment strategy’.

If one considers a with-profits mutual which operates on the ‘revolving fund’ principle with no estate and which aims for a ‘full distribution’ policy, then, on average, policy values including terminal bonus should be above underlying asset values half the time. (They would, of course be below for the other half of the time.) For such an office that is what smoothing would mean.”<sup>4</sup>

123. Bannon replied on 8 November saying,

“I agree entirely with the points you make regarding free capital in the context of a revolving fund principle with no estate”.

He agreed that the sentence quoted by Headdon should therefore be qualified. He added,

“I have to say I am very much in favour of the “full distribution” policy, but when I wrote the article I had more in mind those offices which maintain a cushion of free assets to facilitate smoothing.”

124. During the audit, discussions were held by the auditors (Woodridge & Grenham) with Headdon on the Society’s solvency position. Headdon indicated that the solvency margin was improving and he expected a £200m improvement at the year-end. He also went on to indicate that solvency was measured by monthly estimated valuations done to monitor the solvency margin. From these estimates he would then produce monthly reports on free assets for Ranson.

125. During the 1996 audit, Ernst & Young obtained and reviewed a paper prepared by Nash and Headdon setting out the Society’s projections for the period 1997 to 1999. The issues under discussion that were revealed by this paper included:

- i. The predicted solvency position at 31 December 1997, based on ‘optimistic, most likely and pessimistic’ investment performance.
- ii. The options for the Society to improve solvency if the pessimistic scenario occurred, which assumed investment returns of negative 3%. These solvency options included subordinated loans and passing on a bonus declaration.

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<sup>4</sup> See also quote in chapter 6 at paragraph 47.

- iii. The conclusion that the office had a number of measures available to it. Consequently there was no need to take avoiding action at an early stage merely because a position of regulatory difficulty was seen as an outcome of a possible scenario (but one which might well not happen.) Provided that the solvency position was kept under regular review, as it was in the Society's case, and the full implications were kept in mind when deciding bonus rates, there was no need to allow regulatory considerations to influence behaviour until it was felt that an unsatisfactory outcome was reasonably likely without some change of direction.
- iv. Payments to policyholders were well ahead of what had been forecast, due to an unexpectedly high level of retirements under individual and personal pensions.

The auditors performed a financial statement analysis, comparing the Society's published results for the past 5 years with those of Standard Life and Scottish Widows. This comparison revealed that Standard Life and Scottish Widows had significantly higher free asset ratios than the Society, in addition to showing the higher proportion of investments held in fixed interest securities by the Society.

126. The files for the 1997 audit noted that the investment committee continued to receive monthly reports prepared by Headdon, which included a solvency matrix. This analysed the current free asset position of the Society and showed the change in free asset ratio under various market scenarios. The discussion of the solvency matrix included comments as follows:

“In Form 9 of the DTI return an office has to compare the value of its assets with the reserves to cover policy liabilities (calculated in accordance with regulations.) The reserves need to take into account all guaranteed benefits, including declared bonuses, but not final bonuses. The difference between the assets and the reserves are the available assets for solvency purposes.”

127. The actuarial audit files included extracts from board papers which discussed the Society's statutory solvency position and relevant counter-measures to support this position over various time periods. Possible responses to adverse conditions were set out as follows:

- i. Very short-term
  - a. Increased use of future profits implicit items;
  - b. Declared bonuses could be reduced; and
  - c. Assets could be switched to higher income bearing gilts/equities.
- ii. Short or medium term
  - a. Financial reinsurance arrangements - Headdon commented that reinsurance brought forward future profits and that the DTI might limit the implicit item; and
  - b. Increase subordinated loans.
- iii. Longer term
  - a. A balance had to be struck between providing guarantees, which were attractive to clients, and avoiding those that were unduly onerous in solvency terms; e.g. 3.5% guaranteed interest rate;
  - b. The rate of growth of new business on products, which create a solvency strain, could be reduced.

128. The audit planning section of the files for this year contained a client risk profile, which was in the form of a questionnaire that contained a section relating to the assessment of client solvency issues. Under the question, “Do you have any concerns in respect of your client's ability to continue as a going concern?”, was

marked the response “Possibly.” Accordingly audit identified solvency as being a specific audit risk, which was to be addressed appropriately.

129. As mentioned at paragraph 84 above, the audit file contained a general report produced by Clive Letchford which included reference to solvency.

130. The auditors carried out a SWOT (strengths, weaknesses, opportunities and threats) analysis of the Society. This analysis identified that the Society had a low free asset ratio, which was regarded as a weakness. The analysis also included the following audit commentary:

“ELAS maintains a low free asset ratio, maximising payout to policyholders. Solvency may be threatened by reduced premium and investment income and increased claims.”

The auditors gained some level of comfort from the Society’s own solvency management processes which involved:

“The process whereby regulatory requirements and current margins are reviewed and action taken by management to address any issues.”

This was taken to provide some assurance on the adequacy of the solvency margin and measurement of this in the accounts.

131. The Ernst & Young actuarial manager, Farrelly, held an interim meeting on actuarial issues with Headdon and Loseby to discuss the Society’s solvency position. The meeting notes referred to a discussion of the Society’s use of ‘traffic lights’ to establish solvency status, and a comment by Headdon that he did not have quite the same ‘status’ as Ranson, and that he was asked to present and explain issues that Ranson would not have been asked about.

132. The record of a meeting held between Bannon and Combes of Ernst & Young and Headdon contained the following comments, among others:

“Chris prepares monthly reports which show free assets as a multiple of solvency margins. Two or three times solvency margin is considered adequate.

...

Chris agreed that he was walking a tightrope. ...

As soon as the solvency position changes from green, action is taken to increase the degree of investment in fixed interest and this can quite readily be done by redirecting the very strong positive cash flow currently experienced.”

133. Farrelly prepared a report entitled ‘ELAS Management of Solvency Position’ which supported the Society’s solvency position. He noted:

“Equitable Life’s policy of full distribution, along with recent strong growth, will result in a low margin of free assets. ...

These higher ratios [of competitors] reflect the different distribution policies of these Life offices. ...

Investment management reviews solvency matrix monthly for potential equity/gilt price fall scenarios. ...

Additional solvency management through short/medium and long-term items. The implicit items, subordinated debt and reinsurance options are all considered reasonable.”

134. The auditors identified correspondence from Tritton, the chairman of the audit committee, to Nash which highlighted Tritton’s concerns about the solvency position of the Society. The terms of Tritton’s letter were noted:

“In general and as Chairman of the Audit Committee, I am satisfied that there is proper recognition of the risks undertaken by the Society and that the necessary control mechanisms are in place for the management of these risks. I have, however, one caveat and this may or not be a personal view, I do not

know. However, it is my belief that the Equitable as a mutual is managed too close to the margin. Now I know and I understand and appreciate all the reasons why this should be the case and philosophically do not disagree with the tenets of full, fair and equitable distribution of annual surpluses. However I do believe that there is an increasing risk to the independence of the Society from this annual desire to distribute to the limit. I also observe rightly or wrongly that the effect of such a distribution policy is beginning to tighten our position. If it is not, why are we going down the subordinated loan stock route, why are we taking in more and more from future profits and so on. It may be that this all results from greater proportion of fixed interest stocks in our investment portfolio compared with other houses - I really do not know. All I know is that I am beginning to feel uncomfortable with the business being run so close to the margin and that this could well be the greatest risk we are running.”

135. Nash’s response to Tritton was also noted. It included the following comments:

“The first point I would make is that I do not believe that it is the annual distribution of surplus as declared bonus which is a major contribution to the tightening of margins you describe. ...

It is unarguable that the valuation regulations are more stringent in a low interest rate climate, that the 1994 regulatory changes reduced the room for manoeuvre and that the removal of dividend tax credits has led to higher reserves on pension business.”

Nash then compared the 1992 solvency margin of 2.4 to the 1997 figure of 2.4/2.5, to show that there had been no deterioration, and said:

“If the Board wants significant improvement in the margin of solvency then either a) give greater emphasis to fixed interest stocks, however ELAS would under perform the market. b) retain a significant proportion of earnings from maturing policies. This could take a number of years to generate significant free assets. c) reduce new business levels significantly. Increases vulnerability to predator. d) reduce significantly, or eliminate declared bonuses, as discussed in January Board meeting.”

136. The auditors advised management (Headdon) that in accordance with the actuarial profession guidance and best practice, they should be preparing a financial condition report (FCR), with the following characteristics:

- i. An annual report was required, usually 20-30 pages in length;
- ii. The report should consider the future solvency position of the company for at least five years from the current date; and
- iii. The report should perform sensitivity analyses on all the key assumptions.

Headdon resisted the recommendation that such a report should be prepared. He considered that the information the report would contain was already being provided throughout the year to the Board. Bannon, the Ernst & Young actuary, expressed the view that the Society’s appointed actuary’s view was against the current view of the Institute of Actuaries in this regard.

137. However, it was recorded that Ernst & Young were asked by John Sclater on behalf of the audit committee to provide them with background information about a financial condition report. This information appears to have been edited (at the request of Headdon) as follows. First, from the phrase:

“... the FCR will inform the Board of the solvency in the medium term (typically 5 years) under different scenarios”,

the comment, "typically 5 years," was removed. It was commented that the Society did not do projections so far forward and therefore it would appear important for the

executive and non-executive directors to be aware of what was generally seen as a medium term timescale. Second, the sentence:

“I enclose as an appendix to this letter a summary of the key features.”

was removed from the final letter, along with the appendix. And third, Headdon added a comment that a financial condition report was not required if the designated information had already been provided to the Board.

138. It was recorded that Headdon had commented to the auditors that he was intending to report to the Board that a financial condition report was not necessary and that his current method of continual appraisal was in his view better. The following two extracts from his paper as presented to the Board were noted. First, in relation to five-year projections:

“For a predominantly with-profits office, such as the Society the value of such long term projections is debatable. The projection of solvency difficulties in five years time resulting from certain combinations of adverse conditions is not helpful unless the modelling of how the office would have responded to the emerging conditions is realistic.”

And:

“For example, projecting that the office would be insolvent if current declared bonus rates were maintained, when the set of future conditions is such that rates would certainly be reduced in those circumstances adds nothing to ones understanding of the business.”

139. Bannon concluded in a memorandum that in his opinion Headdon’s approach was satisfactory and covered the required areas, albeit not in a single annual report. He said that it was, of course, up to the Board to tell Headdon if they decided they wanted such an annual report, and they might well do so. The auditors indicated that most actuaries at that stage produced financial condition reports which incorporated the fund results and the financial position of the entity both currently and under future scenarios where different assumptions were used.

140. In the 1999 audit solvency was identified as an area of interest at the planning stage. The auditors made a risk assessment with respect to strains on statutory solvency, identifying the following factors among others:

- i. The combined effect of declining investment values and low fixed interest security yields; and
- ii. The appointed actuary’s practice of active monthly monitoring of the Society’s solvency position, involving stressing solvency under varying scenarios and recommending appropriate actions to the investment committee.

141. The auditors continued to identify ‘possible’ concerns over the Society’s ability to continue as a going concern and it was noted that there was a high likelihood of (continued) business deterioration. Additionally, they identified public criticism and litigation with respect to the Society’s business practices as an issue. The auditors reviewed a Board paper prepared by Headdon, which revealed that no solvency matrix had been prepared for the Board as at 31 March. The explanation given was that the resource commitments involved in preparing the “accelerated HMT returns” made the preparation of the solvency matrix impractical. Headdon indicated that equity markets had moved up 8% since year-end and there had been a small increase in interest rates. He expected that there would be some improvement in the solvency cover ratio, estimated at that time to be around 2.5x.

142. In their review of the regulatory return, the auditors noted in their summary review memorandum that they were satisfied with respect to the reasonableness of the valuation bases used to calculate actuarial liabilities at 31 December 1998, taking account of a resilience reserve of £700m (1997 - £400m), and implicit future profits items, which had risen by £480m. They also noted that that the Society had

received two separate section 68 orders for implicit future profits for 1998. The first, for £850m, was received on 25 September 1998 and the second was issued in December for £1.9 billion, which was to replace the first order issued. While no documentary evidence was seen by audit, Headdon confirmed that the second section 68 order was issued to cover the risk that reinsurance for the annuity guarantees was not obtained. In the event, reinsurance was obtained, and the first order was then applied. Headdon indicated that he had telephoned FSA on 26 March 1998 to confirm that this treatment was acceptable to them.

143. In their review of the regulatory return, the auditors commented that a credit of 50% of the subordinated loan capital value (the maximum permitted) was disclosed in lines 26 and 27 of form 10 and should be taken into account in computing regulatory solvency<sup>5</sup>.

144. In planning for the 1999 audit, Ernst & Young prepared a planning report for the audit committee. In the report Ernst & Young highlighted, in respect of solvency, the following key areas of focus for them during their audit:

- i. actuarial valuation and analysis of surplus;
- ii. other strains on solvency; and
- iii. regulatory compliance.

Ernst & Young also noted that 'solvency strain' and 'fundamental breach of regulations' were key business risks for consideration by them during their audit.

145. It was noted that the financial position of the Society was a key concern for its members and that any new strains on solvency could have an effect on levels of new business and surrenders. In addition to the firm's normal audit work on the statutory return Ernst & Young's actuaries would discuss with management the various scenarios that the Society had modelled and the likelihood and impact of potential adverse experience that could occur.

146. The auditors reviewed the Society's solvency management process, which was under the control of Headdon. The objective of the process, as noted by the auditors, was:

"To maintain solvency at an acceptable level whilst, at the same time, fulfilling the Society's policy of full distribution and holding a mix of investments most likely to maximise the value of policyholder bonuses."

147. The audit files recorded that the auditors had identified the recurring reports generated as being:

- i. Reports to the Board:
  - § Monthly reports showing the balance sheet and the estimated solvency position;
  - § A more detailed quarterly assessment of the emerging solvency position with commentary on trends; and
  - § Annual financial projections for the following three years incorporating one-year solvency projections on a range of scenarios.
- ii. Reports to the Investment Committee:
  - § Monthly solvency information incorporating a matrix of solvency positions under a variety of scenarios with 'traffic lighting' to help interpretation.

148. The audit review carried out on the regulatory return highlighted the auditors' initial estimate of the long-term business fund, as at 31 December 1999, at £26 billion. This figure included a resilience reserve of £1.55 billion (£1998 - 700m)

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<sup>5</sup> Compare paragraph 151 below.

which was calculated on a basis consistent with that of the prior year. Ernst & Young continued to have 'possible' concerns over the Society's ability to continue as a going concern and it was also noted that there was a high likelihood of (continued) business deterioration. Additionally, audit identified public criticism and litigation with respect to the Societies business practices to be an issue.

149. The auditors' conclusions with respect to the solvency of the Society included:

- i. The appointed actuary actively monitored the Society's solvency position. He advised the Investment Committee each month of the effect on solvency of a range of scenarios concerning reductions in the market value of equities and changes in fixed interest yields. There were a number of actions that the Society would take if solvency dropped significantly, e.g., reduce bonuses and/or a switch from equities to fixed interest securities, although either of these could have a detrimental effect on the Society's future business.
- ii. Ernst & Young's actuaries had reviewed the Society's valuation reports and had satisfied themselves that the appointed actuary's approach had been reasonable. On the specific matter of the annuity guarantees, they had reviewed the Society's analysis of its exposure and had concluded that the reserve for these had weakened the Society's position. Actual solvency had increased considerably towards the year-end as a result of market movements. However this position was reversed in January 2000.

150. The auditors reviewed the Hyman Court of Appeal Judgment of 21 January 2000 and acknowledged that there had been a 2:1 decision 'in favour' of the appeal. The audit file contained these notes of the judges' conclusions.

151. The audit files also contained notes on implicit items for future profits and the subordinated debt. In respect of the former it was noted that a section 68 order had been obtained by the Society on 19 November 1999, which allowed implicit future profits up to a maximum of £1 billion to count towards the required margin of solvency. In respect of the subordinated debt, the file noted that an additional section 68 order had been obtained by the Society on 19 August 1997 which enabled the Society to disregard, for the purposes of regulation 60 of the 1994 regulations, amounts owed under a loan agreement dated 4 August 1997 up to an amount not exceeding 50% of the Society's required margin of solvency.

152. Treatment of the annuity guarantees was a live issue for the 2000 audit as discussed above. In addition, the audit planning report to the audit committee highlighted the following key areas of focus for Ernst & Young during their audit, in relation to solvency, namely:

- i. progress on the sale process, impact on the format of the accounts and the going concern basis of accounting;
- ii. actuarial valuation and investment valuation;
- iii. risk management and compliance with the Turnbull guidance; and
- iv. regulatory compliance.

153. At audit planning stage, the auditors made an assessment of the audit implications of the sale of the group as a going concern:

- i. The process aimed at selling the Group would continue throughout the year-end procedures and would result in a significant demand of senior management time in the coming months.
- ii. Given the financial position of the Society, until a sale is agreed the Directors will need to justify the preparation of the accounts on a going concern basis.
- iii. The management of data-rooms, vetting of potential purchasers, management of advisors and communicating to policyholders could divert

the attention of the Directors from business as usual issues during this period.

- iv. Ernst & Young would assess with management in the coming months and at the year-end the Society's basis for treating the business as a going concern. This assessment would depend on the continuing business of the Society and the progress of the sale process.
- v. Audit testing would assess the extent to which key controls such as suspense accounts were being maintained during this demanding period. This testing would take place in September and November and the audit findings would be communicated to management during those audit visits rather than post year-end.

In their risk assessment, the auditors continued to have 'possible' concerns over the Society's ability to continue as a going concern and it was also noted that there was a high likelihood of (continued) business deterioration. The auditors went on to assess the finance director's competence as being weak.

154. Ernst & Young presented a report of findings relating to solvency and the going concern basis, to the Board. Papers presented to the Board in January had shown that there was a draft solvency position on the regulatory basis as at 31 December 2000 of 1.3%, which reflected £350m in assets. This had demonstrated that there was a clear solvency risk for the Society, and that affected the issue whether the company should be regarded as a going concern. Ernst & Young commented:

- i. That the risk at the date of the report was that the Society could become insolvent on a statutory basis, which was a conservative basis, and was defined after deducting the required minimum margin. If the margin were breached it would not be the end of the road. The Society would then have to present a plan to the regulators showing how they intended to regain solvency.
- ii. Since the year-end, there had been a significant switch into gilts, which had improved the statutory position by £500m. Also, the initial £500m payment from the Halifax was expected to be received in the immediate future. However, market movements since the year-end had reduced the free assets by £300m. The net effect of this on the FSA basis was to improve solvency to 3.1%.
- iii. If a satisfactory scheme could be found to settle the annuity guarantee issues, an additional payment of £250m would be due from Halifax. An additional £250m would be available if the sales force were successful.
- iv. The company was closed to new business. There would not be new business strain. All other things being equal, this should progressively improve the solvency position of the fund.
- v. The equity-backing ratio of the fund was currently 62%. Whilst this was lower than an average ratio for an open fund, it appeared high when contrasted with other closed funds. Ernst & Young recommended that the Society adopt a mechanism such as an asset liability model to test the suitability of its investment profile on an ongoing basis.
- vi. The auditors had been told that a paper on managing closed funds (including the use of asset liability modelling) was being prepared by advisors of the Society.
- vii. The solvency position included an implicit item of £1bn for future profits (correspondence with GAD had indicated that this was part of an allowable future profits amount of £2bn). This excluded margins payable under the reinsurance contract with Irish European Reinsurance Company. Under the Financial Services and Market Bill, this would no longer be available to support solvency.

- viii. The Society was in close and regular contact with the FSA in order to manage the company in an appropriate manner, with due regard to policyholders' interests and the regulators' requirements.

155. In their report to the audit committee on the audit results, Ernst & Young raised the a range of issues in respect of the appropriateness of applying the going concern basis in preparing the accounts:

- i. As a result of the Society closing to new business and due to well-publicised concerns over its solvency many readers of the accounts would question the appropriateness of the going concern basis of preparation.
- ii. The going concern concept was defined in accounting standards as follows:

“The enterprise will continue in operational existence for the foreseeable future. This means in particular that the profit and loss account and balance sheet assume no intention or necessity to liquidate or curtail significantly the scale of operation.”

An important consequence of such accounting requirements was that, when preparing the accounts, the directors should satisfy themselves as to whether the going concern basis was appropriate, as they were obliged to make a specific statement to that effect.

- iii. The auditors had recommended to the audit committee that the Board formally consider and resolve this issue at its March 2001 meeting.
- iv. Notwithstanding the importance of such consideration by the Board, factors which might indicate that the Society continued to be a going concern were:
  - a. although the Society had closed to new business, it continued to transact in-force insurance business;
  - b. the appointed actuary had stated that the Society continued to meet solvency requirements; and
  - c. the Halifax transaction had generated £500m since the year-end and might realise a further £500m for the Society.
- v. There was however uncertainty about the quantification of the annuity guarantee provision, and the Society's inability to cap the GAR liability would have the impact of curtailing investment allocation and would make solvency very tight if markets fell further.
- vi. Ernst & Young considered that the statement made by the directors about 'going concern' should reflect the decision to close the Society to new business.
- vii. Ernst & Young had prepared a comprehensive technically based guidance note on going concern, to assist the directors in carrying out their duties with regard to determining the appropriateness of the going concern assumption.

156. The actuarial audit summary review memorandum included the following with respect to the analysis of surplus:

“An analysis of surplus is not carried out until later in the year. We believe that this should be brought forward as soon as possible. Charles Thomson has been asked to prepare a paper for the Board meeting on 28 March 2001 setting out the expected financial position of the Society in the 12 months following the signing of the accounts.

This will form an important part of the Board's consideration of the going concern question.”

157. Ernst & Young noted findings relating to the transaction with Halifax plc as a relevant post-balance sheet event. They reported to the Board:

- i. On 5 February 2001 the Society had signed a deal with the Halifax plc for the sale of its operating assets, sales force and its non-profit and unit-linked business for a payment of up to £1 billion into the with-profits fund. The with-profits fund remained a mutual and closed to new business.
- ii. On 1 March 2001 the Society had received £500m with the potential of a further £500m if certain conditions were met. £250m would be received if the Equitable achieved a settlement between the guaranteed and non-guaranteed annuity rate policyholders and a further £250m would be received if the sales force achieved certain sales targets by 2004 (also contingent on the settlement being achieved). The sale was not subject to a members' vote because the with-profits fund would remain a mutual. The 2000 accounts did not include any benefit in relation to the post year-end receipt of the first £500m or a favourable outcome of a GAR settlement.
- iii. Halifax had two main life assurance operations: Halifax Life and Clerical Medical.
- iv. Details of this event were disclosed in note 22 to the accounts.

158. Ernst & Young's report to the audit committee noted that the 2000 FSA return would take benefit for the present value of future margins amounting to approximately £1 billion<sup>6</sup>; that the inclusion of this implicit item had been approved by the FSA during 2000; and that FSA had also reviewed and approved the current GAR reinsurance treaty. The report further noted that for the purposes of the regulatory return it would be necessary to make several adjustments to the valuation of assets and liabilities used for the purposes of the Companies Act accounts. The principal adjustments, in addition to the implicit item, and their effects, were identified as the need to provide for a resilience reserve of £1.8 billion, and the removal of the balance sheet value of deferred acquisition costs of £190m. It was stated that amounts that might be received by the Society under the GAR reinsurance were repayable out of future margins to the extent that such margins arose. Since FSA had reviewed and approved both the calculation of the implicit item and the latest reinsurance treaty Ernst & Young said that they were satisfied that there was no double counting of future profits between these items.

159. Other solvency points were discussed in the later stages of the 2000 audit. However, since reporting for this year represented Ernst & Young's record of audit overall, it will be more appropriate to deal with these late reports together, after commenting on other audit issues of a repetitive nature over the period.

#### New Business

160. New business was a focus for audit review throughout the period. In the course of the 1990 audit Ernst & Young reviewed correspondence between Ranson and GAD, in which GAD raised, in particular, the need to reserve for policy surrenders and for possible new business strain, especially in the light of the Society's 'full distribution' policy. This issue was raised specifically with respect to with-profits bonds, but alerted audit to these reserving issues more generally.

161. In the course of the 1991 audit, the auditors reviewed press releases relating to the Society that had been issued during the year. From their terms, the auditors were alerted to an unusually high increase in single premium business sold by the Society. They questioned the resulting level of financing strain, and there were discussions between audit and the appointed actuary on this topic. The auditors noted that they had been told that as at the end of 1991 the accumulated effect of

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<sup>6</sup> 1999: £925m.

financing new business strain was £250m. The Society's approach to managing such strain was to 'lend' the necessary sum from policyholders' funds to a notional management company. The debt would then be repaid to policyholders on their departure from the fund as a factor in the terminal bonus mechanism.

162. The topic was reviewed again in the course of the 1992 audit. From a review of board minutes, the auditors identified the Society's policy and approach to dealing with new business strain. The item was again estimated to have a value of £250m at year-end. Auditors discussed the matter with Headdon, who indicated that the rate of growth in the loan value was slowing as the Society was beginning to recoup its costs from periods of high new business growth. The auditors concluded that financial strain would not affect the ability of the Society to do business.

163. During the 1993 audit conclusions in respect to new business were noted in the summary review memorandum. It was recorded that audit considered that the high level of new business growth attracted by the Society over the past few years would have resulted in some new business strain. However the auditors felt that the impact of the associated potential strain was mitigated by the fact that much of the Society's new business was recurrent single premium business, in respect of which no significant problems would arise. No comment was noted in respect of this topic in the following year.

164. New business strain returned as a factor in planning the 1995 audit. The auditors identified two 'critical success factors' regarding new business strain:

- i. Monitoring the capital requirements of business growth so as to avoid undue financial strains, and
- ii. Expanding the product bases to reduce dependency on pensions business.

However, there were no further comments. New business strain was not identified as a factor of importance in the following year.

165. In dealing with the 1997 audit, the auditors' financial SWOT analysis identified, among the Society's weakness, the fact that:

"93% of ELAS's business relates to pension products, increasing the Society's vulnerability to changes in market trend and Government legislation and increased claims as more personal pensions mature."

Furthermore audit planning identified the pension maturity profile as an issue, which would be reviewed by analytical procedure:

"Review future maturity profile products and compare to management forecasts and budget. Does the maturity profile reflect management predictions and investment profile."

166. In 1998, there was a rehearsal of the treatment of the new business loan. The mechanism was described as follows:

"Loadings are attached to premiums received over the life of a policy, as initial premiums received at the start of a policy are insufficient to fund the expenses incurred in the first year. The shortfall is funded by a loan from the 'with-profits' policyholders. Interest is charged on this loan."

There was no further relevant comment.

#### Pension Transfers

167. Pension Transfers became a topic of interest in 1993. It was recorded that, at the year-end audit-closing meeting, the auditors raised the issue of 'pensions mis-selling (pensions transfer)' with management. Ranson had indicated that the exposure for the Society would be minimal and that accordingly he felt that no provision was necessary. While the valuation did not explicitly provide for such an exposure, there was, in his opinion, sufficient 'fat' in it to cover any exposures that

might arise. Ranson further explained to the auditors that even if there were large amounts of transfers carried out, the Society's exposure would be say 5% of £5 billion, which was not significant in the context of the accounts of the Society.

168. Professor Smith enquired of the auditors whether they had relied solely on Ranson's views in assessing the adequacy of the pensions mis-selling issue. The auditors responded that they had done sufficient audit work to satisfy themselves that no provision was currently needed. This conclusion had been drawn on the basis that the auditors believed that the Society accepted such business mainly on an execution-only basis, which was not where the risk lay. Audit additionally went on to say that, as non-experts, it was difficult to assess the level of any provision that might be required, especially considering the fact that no guidance had been issued by the Securities & Investments Board. Professor Smith accepted the auditors' approach adopted in this area.

169. The topic returned in the 1994 audit. It was recorded that at an internal audit planning meeting the following matters were raised:

- i. Ranson had implicitly provided for £50m with respect to pensions transfers.
- ii. The provision had been made by adjusting an assumed interest rate used in the liability valuation.
- iii. The difficulty faced by audit in auditing this provision.
- iv. All staff subordinate to Ranson were unfamiliar with the approach taken by him in this area and they had referred audit staff directly to Ranson in this regard.
- v. Audit had met with Peter Wilmot to review the complaint file and to discuss any significant issues arising. No matters of concern were raised from this meeting.

170. Grenham of the actuarial audit team confirmed that the Society had strengthened their valuation basis in order to establish an implicit pension transfer provision of £50m. At the 1994 year-end Ranson continued to assert the view that the Society had no material exposure to the pensions transfer issue that was affecting the industry widely. Single premium business sold during 1987 to 1993 was £680m. Guidance issued by the Institute of Actuaries indicated that a provision of approximately 10-25% of 'at risk policies' should be made. The Society considered the value of such policies to be around £300m; however it had not made a specific provision for this, but rather had implicitly provided for this value in the technical reserves.

171. The inquiry review has not identified any key information on pension mis-selling between 1994 and 1998.

172. In the 1998 audit, the adequacy of the pensions compensation provision was resumed as an issue of disclosure. Ernst & Young had reviewed the Society's provision. The auditors said that, superficially, the provision looked prudent, and, if one considered the average Equitable case size, the provision looked reasonable. They noted that the £25m increase in the charge during the year was not explicitly shown, but could be calculated.

173. In their audit planning report to the audit committee for the 1999, Ernst & Young highlighted the pensions review among the key areas of focus for them during their audit. In respect of the 2000 audit the continued pensions review and other products review were again highlighted in the audit planning report to the audit committee.

## **2000 Audit**

### Closing Reports

174. There was a wide-ranging review of audit matters reflected in a series of documents that recorded aspects of audit work generally. The first of these that has to be noted refers to the rectification scheme; the scheme devised to provide compensation for those who might have been disadvantaged by the operation of the differential final bonus policy.

175. The actuarial audit summary review memorandum included comments on the GAR rectification scheme:

“There is a technical provision of £210.9m in the long term business provision held in respect of the 60,000 GAR (guaranteed annuity rate benefit) holders who had retired prior to the House of Lords’ ruling, having elected not to take the GAR. These cases are being reviewed to see who may have benefited from the ruling.

Two groups of policyholders were identified for rectification, these being:

1. The first group is policyholders who didn’t take the open market option, who didn’t take the GAR, but may have taken the GAR in the light of the House of Lords’ ruling. The proportion of policyholders who are assumed to have decided retrospectively to take the GAR is correlated to the excess value of the GAR over the CAR.

2. The second group of policyholders are those who took an open market option, but who might have decided to take the GAR. Of these, 80% are assumed to make a case for rectification, for 80% of the benefit (assuming 20% taken as cash).

The additional value of the benefit taken for each population is taken as 35%, based on recent additional costs. This is mitigated by an allowance of 0-5% for lower bonuses which would have applied.

This approach appears to be reasonable, but will need to be updated to allow for actual experience as the scheme progresses. However, the assumption that 80% of the policyholders make a case for rectification is very much a guesstimate however if the correct percentage was 90% the difference would be of the order of £20m, which is within material limits, therefore we believe the assumptions are reasonable.”

The team noted that they had reviewed policyholder literature and with-profits guides to check the statements made on surrender values.

### Presentation of Results

176. There was a note on the Society’s practice. It set out that the Society’s results were presented in two formats, namely BR1 and BR2. These tracked through the movements in the reserves over the year:

“BR1 This shows last year’s result rolled forward allowing for premiums, claims (net of terminal bonus), unwinding of valuation interest rates and explicit allowance for lapses. This provides an estimated expected year-end reserve. ... This is compared with the result on the basis of the actual data at the end of 2000, using last years’ assumptions. The differences are due to changes in the underlying data. The results show that the estimates are very close to the actual results.

“BR2 This shows an estimated result, based on estimated rolled forward data, but using the new assumptions for the 2000 year-end. This is compared with the actual result on the new assumptions.”

The note stated that the auditors had compared the end result on the old assumptions and the new assumptions, in order to check the reasonableness of the

movements. In order to do this, they had used high level reasoning based on annuity factors, and varied the interest rates and mortality assumptions. As a result of these checks, they were satisfied that the movements reflected the underlying change in assumptions.

177. In relation to deferred acquisition costs, it was noted that the accounting policy adopted historically was that for the recurrent single premium type of contract where a series of future premiums was expected, only a proportion of the acquisition costs in the year of sale was covered by the premium loading received in that year. The likely change in policyholder behaviour as a consequence of the decision of the Society to go into run-off, was that there would be a reduction in future premiums. It was necessary for decisions made regarding future premiums for the purposes of the provision to be logically consistent with the treatment of deferred acquisition costs. 'Group Actuarial' had processed an acceleration in the amortisation of deferred acquisition costs for paid-up policies which did not have a GAR. This change was made to reflect the expected increased rates of policy turnover as a result of stakeholder and the events impacting the Society in 2000. It was said that, in view of the assumptions about future contributions for GAR policies, it would be inappropriate to accelerate the amortisation of deferred acquisition costs in respect of those policies.

178. The continued use of implicit future profits items was discussed. The auditors had reviewed correspondence between the Headdon and FSA relating to the Society's application for a section 68 order for a future implicit profits item. The correspondence reviewed reveal that the Society had applied for the use of £1.1 billion in future profits and included a certificate from the appointed actuary in support of this application. The certificate stated that the future profits used in the calculations were "in excess of sums that may be required to meet claims recovery premiums payable under the treaty...".

179. An appendix contained supporting information on the future profits calculation, which disclosed a value of £3.3 billion, suggesting that the proposed use of £1.1 billion was easily supported by future profits. The auditors commented that the subsequent House of Lords' ruling would have had an impact on the future profits used in these initial calculations, and requested further information of the Society in this regard.

180. At a meeting held on 22 February 2001 with the actuarial audit team, Charles Thomson confirmed that the section 68 order for the use of implicit items was still in place and that Society would be using £1 billion in their FSA return. Thomson noted that the FSA had requested a specific sign-off from him on the issue, confirming that there was no double counting of future margins between the implicit items and the GAR reinsurance. Audit sought to corroborate this independently.

181. The Society had indicated that, whilst there was no regulatory requirement to do so, it would be prudent to take account of the effect of the House of Lords' judgment. Accordingly, Ruth Loseby of the Society's actuarial team had explored three alternative methods as follows:

- i. Retrospective method = £1.8 billion (lower value of both methods used)
  - a. Method 1: deduct from past profits the additional cost of GAR liabilities that would have been paid out had House of Lords' judgment applied. Plus reduce profits for reduction in final bonus included in rectification scheme if had applied during this period = £2,650m.
  - b. Method 2: more prudent to reduce estimated future profit calculation by estimated future costs of GAR's following the House of Lords' judgment (£2.6 billion + £0.2 billion). Assume a 60% take-up on retirement and 90% of benefits taken in GAR form (considered very prudent) = £1,793m.
- ii. Overriding limit PVFP = £2.5 billion

In assessing margins in future premiums and reserves, account was made for the potential to double count for the reinsurance treaty. Also excludes double counting in relation to the reinsurance treaty.

The conclusion reached was that in all cases the use of £1.1 billion at 31 December 2000 was justified. Consequently £1.0 billion was used in form 9 of the regulatory return.

#### Subordinated Debt

182. With regard to recent developments, namely the closure of the Society to new business and its then intent to sell to Halifax, the auditors reviewed the subordinated debt offering circular, to assess whether these developments had triggered any collateralisation events (ie need to repay principal capital and any outstanding interest). Audit stated that, given the current low solvency margin of the Society, the Board should consider the implications of insolvency on the existing subordinated debt.

183. As disclosed in the notes to the accounts, ELF plc, which was a wholly owned subsidiary of the Society, had issued £350m of subordinated bonds, the proceeds of which were lent on to the Society. The Society also acted as guarantor of the bonds. The offering circular for the bonds stated that if the Society transferred all or “a substantial part” of its long term business to another body, it must ensure that the whole of the share capital of ELF plc and all the liabilities and obligations of the Society relating to the guarantee were also transferred. A “substantial part” was defined as any part that, as at the most recent valuation date, represented 50% or more of mathematical reserves relating to policies entitled to share in the surplus of the Society.

184. It was recorded that management did not believe that the proposed transaction with Halifax triggered the requirement to make the transfer of the obligations under the ELF plc scheme. Ernst & Young stated that they concurred with this view on the basis that, under the proposed deal, the Society would not transfer the majority of its existing long-term business (ie the closed fund) to Halifax. They had reviewed the loan covenants in view of the current financial position of the Society and had not identified any breaches of the covenants.

#### Financial Reinsurance

185. On 2 February 2001, Alan Pielage of the Society wrote to Bannon informing him of two matters relating to the GAR reinsurance treaty:

- i. The contractual terms regarding take-up rates had changed from 25% to 60%, and
- ii. The treaty would be terminated when the Society duly changed its bonus practice regarding GAR's in response to the House of Lords' judgment.

186. The audit actuarial summary review memorandum (based on information received by audit from the Society during February 2001) contained the following final assessment of the reinsurance treaty and its financial implications:

“A reinsurance treaty is in place to mitigate the impact of the GAD reserving basis on the FSA returns. The reinsurer is Irish European Reinsurance Company Limited.

Under the terms of the reinsurance, if the value of the benefit paid out during a year through the GAR being exercised is more than 60% of the total value of benefit paid out, the reinsurer meets the additional cost. The benefit being valued for this purpose is the basic sum assured plus attaching bonuses.

A recovery premium is then due from the reinsured to the reinsurer equal to a proportion of the terminal bonus cushion, where the proportion is determined as the excess of the take up rate over 60%.

In practice, a delay is applied to the payment of the recovery premium to the reinsurer.

An annual premium is paid to the reinsurer of £700,000 p.a., increasing with Retail Price Inflation on an annual basis. This was increased from the £625,000 payable in the previous year, to reflect the increase in the assumed take up rate to 60% from 25%, following the House of Lords' ruling.

Correspondence with GAD mentions that while the reinsurance arrangement previously in place remained, the net basis would remain broadly unchanged. A subsequent letter (9<sup>th</sup> January 2001) indicates that GAD are expecting ELAS to review their assumption following the House of Lords' decision. There is no specific mention of the 60% reinsurance treaty."

187. In an audit file note dated 6 March 2001, the technical aspects of the accounting treatment of the reinsurance contract were discussed. The ABI SORP (S194) requirements relating to financial reinsurance were dealt with, and audit concluded that they were not keen to apply this method, as they believed the recognition of future margins was imprudent.

188. On 12 March 2001 Bannon contacted Ruth Loseby of the Society and asked if there was any correspondence with the FSA regarding the GAR reinsurance treaty. Loseby responded by saying there wasn't; however the treaty had been in force for over 2 years and the FSA had not challenged it. She went on to add that the FSA were heavily involved through the period when the reinsurance was being negotiated. Bannon informed Gregor Stewart of this, who said he would raise the point at the forthcoming audit committee meeting to be held on 14 March 2001.

189. The auditors' findings and treatment of this reinsurance contract were communicated to the Board as follows:

"At 31 December 1999 the Society had entered into a reinsurance contract with Irish European Reinsurance Company Limited. This contract had been the subject of considerable commentary primarily because it lapsed following the House of Lords' ruling. The contract had no impact on the 1999 Companies Act Accounts but did give relief in arriving at the GAR provisions established for the purposes of calculating the solvency reported to the FSA.

In 2000 the calculation of the GAR provision in the FSA return assumed a take-up rate of 90% on the basis of guidance issued by the Government Actuaries Department. The gross provision was then reduced to take account of a revised reinsurance contract under which Irish European Reinsurance Company Limited would initially meet the cost of GAR take-up in excess of 60%. The impact of this reinsurance in the FSA return was to reduce the liability by approximately £900m.

An important feature of the reinsurance treaty was that the cover it provided ceased on the insolvency of the Society.

No recognition had been made of the reinsurance contract in the Companies Act Accounts. The level of take-up assumed for the purposes of the GAR provision in the accounts was at the point where the revised reinsurance contract became effective.

Given that the solvency of the Society was very low at the year-end the continuing provision of reinsurance cover was of concern. However, since the treaty did not define "insolvency", the Appointed Actuary had assumed that this meant Companies Act rather than FSA regulated solvency.

Notwithstanding current solvency cover, the directors should understand the implications of solvency on the reinsurance contract and ensure that this position was continuously monitored."

Regulatory Return for 2000

190. A meeting was held between Ernst & Young and the Society on 29 June 2001 to discuss the 31 December 2000 regulatory return. Attendees at this meeting were: Peter Nowell, Charles Bellringer, Paul McNamara, Rob Holman, Gregor Stewart, and Angus Millar. Ernst & Young had called the meeting to discuss:

- i. The Society's letter to Martin Roberts of FSA, dated 28 June 2001 about the Society's position;
- ii. An additional paragraph to the appointed actuary's certificate on the FSA return;
- iii. Any consequential impact on the audit opinion on the returns; and
- iv. The duty of Ernst & Young to report to FSA under SAS 620.

191. Bellringer confirmed that the Society had sent a letter to the FSA on 28 June and he outlined the events leading up to the submission of the letter:

- i. There had been no bonus declaration at 2000 year-end;
- ii. Contractual claims continued to receive an 8% interim bonus;
- iii. The decline in equity values in first part of 2001; and
- iv. There had been a higher level than average of contractual claims.

All these events had exacerbated the Society's weak solvency position.

192. The Board met on Wednesday 27 June but failed to reach any conclusion on what action to take to improve the solvency position. Hence the chief executive had felt it necessary to send a letter to FSA to that effect prior to the filing of the returns. For the same reason the appointed actuary had added a paragraph in the return, the wording of which was accepted by FSA.

193. Nowell explained that claims were running at £1.1 billion per quarter, many of these being contractual and for that reason were not subject to the market value adjuster (MVA). Thus policyholders were receiving claims well in excess of their asset share. He stated that, in terms of actuarial guidance PN 8, he must not set mathematical reserves at a level which might lead directors to declare too high a bonus rate. At year-end the excess of policy values over available assets had been 10% (which was in Nowell's opinion about the maximum that should exist). The excess had grown to 18%. Nowell agreed that such an excess was likely to result from smoothing but that, after 6 months, action should be taken. From the 10% level of excess, policy values had increased 4% (interim bonuses for 6 months) while £500m had been received from Halifax, bringing the excess to 18%]. Nowell felt that a measure similar to an MVA was necessary for contractual claims and that reducing interim bonus rates to nil would achieve this. He considered the current bonus policy to be unsustainable. In the absence of any appropriate Board action he felt obliged to set aside specific reserves for some part of future terminal bonus. On that basis, at the current date, the Society's form 9 position would be in deficit. However Nowell and Bellringer confirmed that the Board would take appropriate action to provide a positive solvency position. It was expected that the Board meeting of 2 July would address this issue. McNamara and Holman stated that, for the same reasons that the appointed actuary had to report to FSA, audit had to do this under SAS 620.

194. An internal follow up meeting held by Ernst & Young on the 2 July 2001 with respect to the completion of Society's FSA returns was attended by Holman, McNamara, Stewart and Millar of Ernst & Young and also by a solicitor advising Ernst & Young. Following on from Ernst & Young's meeting with the Society on 29 June 2001, the following issues arose:

- i. Whether Ernst & Young had a duty to report to the regulators under SAS 620 and the various provisions of the Insurance Companies Act 1982, and
- ii. What they should be saying in their regulatory return audit report.

The factual context identified was that policy values were in excess of asset shares and the Board did not have an appropriate policy position to deal with this. The appointed actuary therefore considered it necessary to reserve for two years' terminal bonus at 30 June 2001, which would render the Society insolvent in regulatory terms. The appointed actuary was to modify the standard certification in the regulatory return. However the appointed actuary felt that the Board would support a policy change. In the event, the full facts were set out in the appointed actuary's report, and the audit report was left unchanged. Audit reported in terms of SAS 620. While the audit certification (dated 27 June 2001) in the regulatory return was not qualified, it dealt with the fundamental uncertainty.

#### 2000 Audit Conclusion

195. The audit file contained the following conclusion in support of the audit opinion given in respect of the 31 December 2000 accounts:

“On the basis of our work performed to date, we anticipate issuing an unqualified auditors' report in respect of the statutory accounts. However, as a result of significant uncertainty regarding policyholders' behaviour in the future with regard to GARs the notes to the accounts refer to a fundamental uncertainty in estimating the GAR provision and we have included a fundamental uncertainty paragraph in our audit opinion...”

196. McNamara, prepared the following file note in support of the conclusions reached by the audit team:

“In arriving at the technical provisions in the balance sheet of the Society for the year ended 31 December 2000, it has been necessary to increase the technical provisions for amounts payable to policyholders by approximately £1.6 billion in respect of the obligations for the guarantee annuity rate options. This increase follows the decision in the House of Lords, which in effect has made the taking of the guaranteed annuity rate option far more attractive for policyholders.

In arriving at the provision there are four factors, which are crucially important in its computation. Two factors – interest rates and mortality – are reasonably straightforward in so far as they are assumptions that have to be made in other parts of actuarial valuation and therefore are based on current experience of mortality or interest rates. The third factor relates to the extent to which policyholders will continue to make contributions. We have looked at the underlying assumptions and whilst there is the possibility that GAR policyholders will be more enthusiastic about investing in the future, they are a discrete and declining group, and there is a reasonable basis for believing that the assumptions made about the levels of future contributions are realistic and indeed may be prudent. They have certainly been strengthened since last year.

The fourth assumption gives rise to greater difficulty. Based on the decision in the High Court and the Court of Appeal, there was the belief that the guaranteed annuity rate option was not generally speaking attractive to policyholders and experience had shown that there was a very low level of take-up of the order of 1 – 2% which led to the disclosure of £50 million being the best estimate of the cost. However following the House of Lords' decision in July 2000, the take-up experience by policyholders has been substantially greater. We are currently checking the figures but the experience in the September to November period was approximately a 53% take-up. The experience in December was 57%.

The draft technical provisions have assumed a take-up rate of 60% and we are awaiting the January take-up rate to be advised to us. Clearly at 60% there is not much headroom over the experience in the last four months, and there has to be a belief that the experience in that period may well not be representative of what will happen in the future. A key element of reducing the exposure is that most policyholders wish to exercise the right to take the 25% cash lump sum out of their accumulated fund, and therefore the take-up rate immediately drops to 75%. Actual experience shows that the cash lump sum exercise is approximately 22.5% so the ceiling on the take-up rate is 77.5%.

Since October/November the Society has been offering policyholders the right to split the fund such that part of the fund can be applied at a single level annuity and the balance of the fund can be applied to buy a joint survivor annuity. The experience of take-up of the joint survivor annuity in November and December was very low and far below what we would have been expecting. It is possible that all the uncertainty surrounding the law case has kept policyholders back from exercising their annuity rate option such that in recent months there has been pent up demand, which will now abate, and there will be a more normal level of exercise. However this remains speculative and is clearly not supported by historic evidence. The take-up rate also in the September/December period was driven down by the propensity of some policyholders to flee the Society including GAR policyholders, which certainly had a benefit.

The Halifax deal may temper the propensity of policyholders to flee and indeed there is already some indication that, whereas surrenders were running at about four times normal prior to the Halifax deal, they are now down to about twice normal. If the propensity to flee is reduced it could drive up the take-up rate further. There is no point looking at February experience as, following the Halifax deal and the suggestion that there will be a Scheme of Arrangement, there is an in-built bias now for policyholders who want to take the GAR option to exercise the option rather than wait for the Scheme of Arrangement. Furthermore those policyholders for whom the option is unattractive will be far more attracted by a possibility of their policy benefits being enhanced in the future by 20%.

In the actuarial work performed by Tim Roff's group the reports given by us stressed that the take-up rate estimates were entirely those of the Society as at that time there was no experience of what the take-up would be.

Based on discussion with Peter Standish, as the Independent Partner, and looking at the financial statements, I have drafted a Fundamental Uncertainty note which is attached and I also attach the first draft of the footnote for inclusion in the Annual Report & Accounts to which it refers. The sensitivity of the movement is such that if the take-up rate is at 60%, which has been used in the accounts, rose to 70%, there will be an increase of £300 million in the technical provisions. This approximates to 1% of the technical provisions on that basis would be seen as immaterial. However, the corresponding entry would be a reduction of £300 million in the fund for future appropriations of £2.5 billion. In so far as the FFA in effect covers the terminal bonuses, such an adjustment might be seen by the more astute to indicate that the Society should increase the market value adjustment to policyholders surrendering early from 10% to a higher figure and they might be tempted therefore to run before the MVA gets adjusted.

There is an additional complication. As has been widely reported in the press the Society entered into a reinsurance contract in 1999, which lapsed following the House of Lords' decision. A new contract has been entered into which in effect gives benefit if the take-up rate exceeds 60%. However, the reinsurance contract is a form of finite reinsurance for which there will

inevitably be some pay back out of future margins. I am not an enthusiastic for giving any recognition to financial reinsurance contract in the Companies Act accounts whatsoever. We did not do so in 1999 which following all the controversy that has arisen is just as well. It is also true that if the take-up rate falls to 50%, which was really the initial estimate of the company, then the Technical Provisions are overstated by the corresponding £300 million, which would benefit the Fund for Future Appropriations, and indeed various other aspects of FSA solvency.

There is a further aspect to this. If in due course the Scheme of Arrangement is adopted whereby the GAR policyholders give up their GAR option rights for a mixture of enhancement to their reversionary bonuses and their terminal bonuses, then this problem in effect falls away. However the details of the Scheme of Arrangement are embryonic at the present time and there is of course no certainty or even indication of certainty that the relevant classes of policyholders will support whatever proposition is put in front of them.”

### **Comment**

197. As stated at the outset, the narrative in this chapter has proceeded substantially without comment. I have taken comfort from the auditors' findings in arriving at factual conclusions in earlier chapters, and to a lesser extent have relied on material from this summary in later parts of this report.