

The Office of Sir John Chadwick

Appointed by HM Government as independent adviser in relation to The Equitable Life ex-gratia payment scheme

Equitable Life ex-gratia payment scheme

My proposals as to the approach to be adopted and the issues to be addressed

June 2009

1 INTRODUCTION

- 1.1 I have been appointed by HM Treasury to advise on matters arising from the Government's Response to the Report of the Parliamentary and Health Service Ombudsman on her investigation into the prudential regulation of the Equitable Life Assurance Society. That Report – *"Equitable Life: a decade of regulatory failure"* - was published on 16 July 2008. The Response is dated 15 January 2009. My Terms of Reference are at Annex A to the Response.
- 1.2 The Report sets out the Findings of maladministration resulting in injustice which were made by the Ombudsman in the course of her investigation. Her determinations of maladministration are summarised at Section 6 of Part five of the Report. Her determinations of injustice are summarised at Section 7 of Part five. In its Response the Government indicated its acceptance of some, but only some, of the Ombudsman's Findings. The Findings which the Government has accepted are summarised at Appendix 1 to my Terms of Reference.
- 1.3 My Terms of Reference require that, in relation to the cases of maladministration resulting in injustice which the Government has accepted ("the accepted Findings"), I will give advice on:
- (i) the extent of relative losses suffered by different classes of policyholders in respect of each case of maladministration, taking account of, among other things, wider market conditions during the period under consideration, and comparable insurance products available over the same period;
 - (ii) the proportion of those losses which it would be appropriate to apportion to the public bodies investigated by the Ombudsman, as opposed to the actions of Equitable Life and other parties;
 - (iii) the classes of policyholders which have suffered the greatest impact as a result of maladministration; and
 - (iv) factors, arising from this work, which the Government might wish to take into account when reaching a final view on determining whether disproportionate impact has been suffered.
- 1.4 My Terms of Reference further require that, in formulating my Advice, I shall:
- (i) accept as correct and be able to consider all of the Ombudsman's Findings of both maladministration and injustice in so far as those Findings are accepted by the Government, but disregard Findings which are not accepted;
 - (ii) accept as definitive the Ombudsman's account of the events at Equitable Life, as set out in the narrative sections of Part one of her Report and in Part three;
 - (iii) make such other findings of fact (if any) as I may think necessary in the light of the evidence contained in the publicly available reports produced to date, including the Penrose Report, the Ombudsman's Report and the Government's Response to that Report;
 - (iv) review additional evidence should this be necessary to fulfil the terms of reference, but having regard to the need, so far as possible, for an expeditious process; and

- (v) if I deem it necessary, seek written representations as appropriate from interested parties.
- 1.5 It is important to keep in mind that I am required to disregard those of the Ombudsman's Findings (whether of maladministration or of injustice) which the Government has not accepted in its Response.

The scope of this document

- 1.6 In carrying out the task set by my Terms of Reference I need, first, to identify with some precision the specific issues which I must address in order to reach a view as to the extent of relative losses suffered by each relevant class of policyholder (an expression which includes annuitants) in respect of each of the accepted Findings. I will be assisted in the identification of those issues by a process of consultation.
- 1.7 The purpose of this document is to set out provisional views as to which issues I must address (having regard, always, to my Terms of Reference) and to invite comment on those views. I do not, at this stage, invite representations as to how the issues to be addressed should be resolved. I will do so when the issues to be addressed have been identified definitively.
- 1.8 I approach my task on the basis that I shall not be able to reach a view as to whether it would be appropriate to make a notional apportionment of the relative losses suffered by each relevant class of policyholder between the public bodies investigated by the Ombudsman and others (including, in particular, Equitable Life itself) – and, if it is appropriate to make a notional apportionment, what that apportionment should be – until I have resolved questions as to the basis on which the extent of those losses should be determined. This is discussed in section 3 of this document. Nor do I think that I shall be able to reach a view as to which classes of policyholders have suffered the greatest impact – or as to the factors, arising from my work, which the Government might wish to take into account when reaching its own view as to disproportionate impact – until I have resolved those questions. I invite comment on the matters raised in section 3. I do not, at this stage, invite representations as to how (if at all) relative losses should be apportioned; nor as to whether some classes of policyholders should be seen to have suffered disproportionate impact. I will do so at a subsequent stage.
- 1.9 With those considerations in mind, in the following sections of this document:
- (i) I identify the accepted Findings, setting out (for convenience) the relevant passages in the Report and the Response (section 2);
 - (ii) I explain the approach which I am minded to adopt in reaching a view as to the basis on which the relative losses suffered by each relevant class of policyholder in respect of each of the accepted Findings should be determined; and invite comment on that approach (section 3); and
 - (iii) I identify the specific issues which, adopting that approach, I think I need to address and invite comment on that provisional identification of specific issues (sections 4 to 7).

The way forward

- 1.10 Comments, within the scope of these proposals, should reach my Office not later than 17 July 2009. In the light of those comments – and with the benefit of further analysis by my Office – I expect to be in a position to make an interim report to the Government in the first half of August. I intend that that interim report will contain a definitive statement of the approach that I will adopt in determining relative losses; and will identify, definitively, the specific issues which I will address. As I have said, there will be an opportunity, following publication of that document, to make representations on those specific issues.
- 1.11 Representations and comments in response to these proposals should be put in writing and sent by 17 July to:
- The Office of Sir John Chadwick
One Essex Court
Temple
London
EC4Y 9AR
Email: info@chadwick-office.org
- 1.12 For information about my Office, please refer to its website at www.chadwick-office.org.

A handwritten signature in black ink, appearing to read 'John Chadwick', followed by a long horizontal flourish line.

The Right Honourable Sir John Chadwick

2 THE ACCEPTED FINDINGS

- 2.1 In this section I set out what I consider to be the most relevant extracts from the Report and the Response in relation to the accepted Findings. (References to the Report are in the form Part / Chapter / Paragraph. Page references are given for additional ease of reference.)

The Fourth Finding: scrutiny of Equitable Life's regulatory returns for 1994 to 1996

The Ombudsman's Finding of maladministration

- 2.2 The Ombudsman's Fourth Finding of maladministration is stated at Report 1/11/60 (page 321). So far as material, the Finding is in these terms:

"I find that the failure by GAD, as part of the scrutiny process, to question and seek to resolve questions within the Society's regulatory returns for each year from 1994 to 1996 – related to ... (iii) apparently arbitrary changes to the assumed retirement ages, and (iv) the holding of no explicit reserves for the liabilities associated with ... guaranteed annuity rates – constitutes maladministration. I therefore make such a finding of maladministration against GAD."

The Report contains a more detailed summary of the matters found to constitute maladministration, in respect of assumed retirement ages and guaranteed annuity rates (GARs) at, respectively, 1/10/305-312 (pages 262-263) and 1/10/323-326 (page 264).

Changes to retirement ages

305. The first [issue that arose in relation to the 1994 Regulatory Returns] was the way in which the Society assumed the retirement age that would be chosen by its policyholders when calculating its liabilities. Changes to those assumptions appeared to breach the requirements of the applicable Regulations.

306. The question arose because, in both 1994 and 1996, the Society changed in what appeared to be an arbitrary manner the retirement age it assumed would be prudent when calculating its reserves. On both occasions, the effect of those changes was to reduce the reserves that the Society needed to hold.

307. After July 1988, Equitable wrote large numbers of recurrent single premium personal pension policies, which allowed policyholders to retire without penalty at any time from age 50. Thereafter, a cash sum equal to the guaranteed benefits that had accrued in respect of a policy became available and could be used to buy an annuity either from the Society or, using the open market option, from any other pension provider.

308. In the years prior to 1993, the Society calculated its reserves for these policies by discounting the guaranteed benefits from the age of 50, the earliest retirement age allowed under the policies. That was a prudent approach.

309. However, the Society in its 1994 returns assumed, for the purposes of determining the liabilities in respect of such policies, that personal pension policyholders would retire aged 55. The Society did the same in its 1995 returns.

310. *In the years from 1996 to 1999, Equitable changed its approach again and assumed that personal pension policyholders would retire aged 60.*

311. *In addition, for policyholders retiring between the ages of 50 and 55 – and later between 50 and 60 – this meant that the reserves held by the Society in relation to their policy might be less than the cash sum that would be immediately available to those policyholders by way of guaranteed benefits, or under any other option in those policies, or which was available to buy an annuity from another pension provider.*

312. *The effect of those changed assumptions was that, in all its returns from 1994 onwards in the period covered by this report, the liabilities that the Society showed in its returns, in respect of which it needed to hold reserves, could have been considerably understated. Information that this was so was available to GAD when they scrutinised those returns but GAD took no action until November 2000.”*

Explicit reserves for guaranteed annuity rates

“323. *The final issue which arose was the failure by the Society to reserve for the liabilities associated with those policies which contained guaranteed annuity rates.*

324. *The Society did not make any provision for the liabilities associated with those guarantees, despite the fact that the applicable Regulations required that the calculation of the Mathematical Reserves should include provision for such liabilities. The public bodies told me during my investigation that, by their reckoning, reserves of £275 million and £325 million were omitted from the Society’s returns for 1995 and 1996 respectively. My advisers suggest a higher figure, but either way the omission was, in my view, material.*

325. *Whilst the Society had disclosed the existence of those guarantees within its returns for each year, no information had been provided within those returns about the level and extent of the guarantees since that information had been provided within Schedule 5 of the Society’s 1990 returns.*

326. *This issue, the failure by the Society to establish reserves in respect of the liabilities associated with those of its policies containing guaranteed annuity rates was not noted by GAD in its scrutiny of any of the Society’s returns from 1994 to 1996 and did not come to the attention of GAD or the prudential regulators prior to July 1998.”*

In this context (and in the context of the Sixth Finding), references to information contained in the regulatory returns must be taken to include information in both the main and the appendix valuations.

The Ombudsman’s Finding of injustice

2.3 The Ombudsman’s Finding of injustice is at 1/12/100 (page 346):

“100. *I find that injustice was sustained by any policyholder who relied on the information contained in the Society’s returns for [1994]* to 1996 and who suffered either a financial loss or a lost opportunity to take an informed decision as a result of such reliance. Where a policyholder neither relied on this information nor suffered a loss of either type, I find that no injustice resulted from this maladministration.”*

*The context is such that in relation to these Findings the Ombudsman's reference in this paragraph of the report to 1990 may be read as 1994.

- 2.4 The Report contains a more detailed summary of the matters found to constitute this injustice at 1/12/89-99 (pages 345-46); and there is further elaboration of the consequences of this Finding of maladministration at 1/12/30-32 (page 338) and of the general consequences of all the Ombudsman's Findings of maladministration taken together at 1/12/59-81 (pages 341-344).

The Government's response

- 2.5 The Government's acceptance of the Findings relating to changes to assumed retirement ages and reserves for guaranteed annuity rates is summarised at paragraph 4.77 (page 23) of the Response:

"4.77 The Government accepts those parts of the Ombudsman's finding which relate to: ...

- maladministration and injustice concerning the changes to assumed retirement ages; and*
- maladministration and injustice concerning the failure to hold explicit reserves for guaranteed annuity rates."*

- 2.6 That summary is expanded in relation to maladministration at paragraphs 4.81-84 (page 24):

Changes to retirement ages

"4.81 The Government accepts that Equitable Life's changes to retirement ages were significant and therefore should have prompted GAD to ask questions of the Society so that the regulator could be satisfied that the changes were justified. The finding of maladministration in this respect is, therefore, accepted."

Explicit reserves for guaranteed annuity rates

"4.82 The Government accepts that there was a requirement for Equitable Life to reserve for its GAR liabilities in circumstances in which the GARs were valuable to policyholders (when the current annuity rate fell below the guaranteed annuity rate). Indeed, it is accepted that the prevailing level of interest rates at the end of 1995 was such that the GARs were valuable at that date. A GAR reserve should therefore have been established in the base valuation in the 1995 returns, albeit of a modest amount.

4.83 The Government accepts that GAD failed to confirm whether a GAR reserve was established in the 1995 returns and on this basis accepts this part of the finding of maladministration. However, in this respect, it considers that GAD was entitled to place reliance on the Appointed Actuary to provide full and proper disclosure in the returns in accordance with his professional responsibility. The disclosures of its GAR exposure provided by Equitable Life to the regulator in its returns were not such as to provide either GAD or the regulator with a clear understanding of the nature and extent of Equitable Life's GAR policies or the potential liabilities which the Society might face.

4.84 The Ombudsman places reliance on the information contained in Schedule 5 of Equitable Life's regulatory returns which made reference to the Society's GAR

policies. The Government accepts that Schedule 5, provided to the regulator in 1990, contained information as to the level and extent of the GAR policies. However, at the time of the 1990 returns the GARs were neither valuable nor generally an issue of significance or concern. Given Equitable Life's limited disclosure in the regulatory returns in the years following 1990, there was no good reason in 1995 for GAD to have recourse back to the Schedule 5 statements submitted with the 1990 returns."

And in relation to injustice, at paragraphs 4.101-107 (pages 27-28):

Changes to retirement ages

"4.101 The Government accepts the Ombudsman's finding of injustice.

4.102 Had GAD questioned Equitable Life about its retirement age changes, Equitable Life might well have been able to provide evidence of its retirement age experience so as to justify the changes which it had made. Whilst it is accepted that the regulator ought to have satisfied itself that the changes to retirement ages were permissible, there is no evidence available to show that the changes were, in fact, arbitrary.

4.103 However, the Government accepts that Equitable Life might not have been able to justify their changes to retirements ages and that the regulatory returns might therefore have shown a different picture of the Society's solvency position. In those circumstances, the regulator would have missed an opportunity to act had Equitable been in breach of those regulations.

4.104 Therefore, to the extent that policyholders were misled as a result of reliance on the information contained in Equitable Life's returns (which would in turn have been based on assumptions including Equitable Life's assumed policyholder retirement ages) the Government accepts the Ombudsman's finding of injustice arising from the maladministration identified."

Explicit reserves for guaranteed annuity rates

"4.105 The Government accepts the Ombudsman's finding of injustice.

4.106 The regulator should have required Equitable Life to establish explicit reserves for its GAR liability in the 1995 and 1996 returns. However, whilst the prevailing level of interest rates at the end of 1995 was such that the GARs were valuable at that date (and a GAR reserve should therefore have been established in the base valuation in the 1995 returns) only a modest reserve was required for the 1995 return. Within these parameters, the Government therefore accepts that Equitable Life's returns would have shown a different picture of the Society's solvency position had no maladministration taken place.

4.107 Therefore, to the extent that policyholders were misled as a result of reliance on Equitable Life's returns (which would have shown a stronger financial position in the absence of reserves for GARs) the Government accepts that injustice was sustained as a result of the maladministration found."

- 2.7 In the light of the passages which I have set out, I do not understand the Ombudsman to have found (or the Government to have accepted) that failure by GAD to question and seek to resolve whether the changes that Equitable Life made to its assumed retirement ages in its 1994 and 1996 regulatory returns did, in fact, lead to injustice. The Ombudsman's Finding (and the Government's acceptance) is that those changes (if not capable of being justified by

Equitable Life) might have done so. In those circumstances it seems to me necessary that I should myself make a finding of fact on this question.

The Sixth Finding: financial reinsurance

The Ombudsman's Finding of maladministration

2.8 The Ombudsman's Sixth Finding of maladministration is stated at Report 1/11/101 (page 326):

"I consider that the failure by the FSA, acting on behalf of the prudential regulators, (i) to ensure that the financial reinsurance arrangement was not taken into account within the Society's 1998 returns without an appropriate concession being given, and (ii) to ensure that the credit taken by the Society within its returns for 1998, 1999, and 2000 properly reflected the economic substance of that arrangement, constitutes maladministration. I therefore make such a finding of maladministration against the FSA."

There is a more detailed summary of the matters found to constitute this maladministration at 1/10/397-486 (pages 273-285).

2.9 This Finding may be reduced to two propositions:

- (i) there was no Section 68 concession in place at 31 December 1998, without which Equitable Life should not have been permitted to take the reinsurance treaty into account in its 1998 return: see Report 1/10/432-433 (pages 277-278); and
- (ii) on a true analysis of the reinsurance treaty, it should not have been taken into account in Equitable Life's returns at all: see Report 1/10/450 (page 278).

In relation to the question whether Equitable Life should have been allowed to take credit for the treaty in its 1998 return, it is difficult to see how, in the context of reaching a view as to the extent of relative loss suffered by each relevant class of policyholder, proposition (i) adds anything to proposition (ii) above.

The Ombudsman's Finding of injustice

2.10 The Finding of injustice is at 1/12/146 (page 351):

"I find that, in respect of all those who joined the Society or paid a further premium that was not contractually required in the period after 1 May 1999, any financial loss that they have sustained constitutes injustice in consequence of maladministration. Those affected by that maladministration have also suffered injustice in the form of lost opportunities to take informed decisions about their financial affairs."

The Report contains a more detailed summary of the matters that have been found to constitute this injustice at 1/12/122-145 (pages 348-351), with further elaboration of the consequences of this act of maladministration at 1/12/38-43 (pages 339-340) and of the general consequences of all the Ombudsman's Findings of maladministration taken together at 1/12/59-81 (pages 341-344).

- 2.11 Given the express limitation in the Ombudsman's Findings as to the period in which injustice was suffered, it seems to me unnecessary to consider the effect of the reinsurance treaty prior to 1 May 1999.

The Government's response

- 2.12 The Government's acceptance of this Finding of maladministration leading to injustice is at Response paragraph 4.132, with elaboration at paragraphs 4.133-140 (pages 32-33):

"4.132 The Government accepts the Ombudsman's findings of maladministration and injustice in relation to Equitable Life's use of reinsurance."

Maladministration

"4.133 The Government accepts that the Treaty was such as to raise questions which should have been resolved by the regulator before permitting credit to be taken for it in the regulatory returns. Since Equitable Life was a party to the Treaty (unlike the prudential regulator), these questions raised issues of which Equitable would have been, or should have been, aware."

4.134 This acceptance is based on the fact that there is no evidence that the FSA satisfactorily resolved issues which it (and GAD on its behalf) had raised with Equitable Life as to the requirements of the Treaty. The FSA should therefore not have been satisfied that the executed reinsurance agreement was such as to justify the treatment of the Treaty in Equitable Life's returns for 1998, 1999 and 2000. In particular, the FSA did not resolve concerns as to whether the credit which Equitable Life took for the Treaty in its returns was properly justified by the provisions of the Treaty itself."

Injustice

"4.135 The Government accepts the Ombudsman's finding of injustice in relation to Equitable Life's use of reinsurance. It is accepted that Equitable's returns would have given a materially different picture of Equitable's solvency had no credit for the reinsurance treaty been permitted by the regulator. Notwithstanding this acceptance, the Government wishes to make the following observations on the Ombudsman's injustice finding."

4.136 The Ombudsman has found that, had credit for the reinsurance treaty not been permitted, Equitable Life would have been unlikely to have declared a bonus in 1999 and earlier closure to new business would have followed. It is the Ombudsman's view that such consequences would, "on the balance of probabilities," have followed had the reinsurance treaty not been available to Equitable Life.

4.137 The Government has considered the Ombudsman's analysis leading to the finding of injustice and in particular the alternative scenarios which may have unfolded had credit for the reinsurance treaty not been permitted by the regulator.

4.138 The Government accepts that any consideration of the consequences which might have followed a decision not to permit credit being taken for the reinsurance treaty is necessarily speculative. However, in the context of what is now known about the conduct of Equitable Life, which later did everything

possible to remain open to new business, it is almost certain that Equitable Life would have investigated all possible courses of action so as to be able legitimately to bolster its solvency position in the 1998 returns and to declare a bonus in 1999.

4.139 Such options are likely to have included a combination of alternative reinsurance cover, adjustment of the margins in Equitable Life's regulatory returns, increased use of the future profits implicit item and reducing some of its equity exposure in favour of fixed interest assets, most probably through the use of derivatives. It is also possible, in light of the apparent intentions of the parties to the reinsurance treaty as to its proper interpretation, that had their attention been drawn to the fact that it did not bear such an interpretation, they would have renegotiated its terms.

4.140 These options would have impacted on Equitable Life's published solvency position to different degrees, depending on which were utilised and to what degree, and their availability should be taken into account when assessing the impact and nature of the injustice flowing from this finding of maladministration. Recourse to any of these options would also have impacted on Equitable Life's ability to justify to the regulator its ability to pay a bonus in 1999."

- 2.13 The effect of my Terms of Reference, as it seems to me, is that those paragraphs of the Response qualify the extent to which I am obliged and permitted to take the Ombudsman's Findings of injustice into account when determining the extent of relative losses suffered by classes of policyholders in respect of the Sixth Finding.

The Tenth Finding: information provided by FSA after Equitable Life closed to new business

The Ombudsman's Finding of maladministration

- 2.14 The Ombudsman's Tenth Finding of maladministration is stated at Report 1/11/160 (page 332):

"I consider that the misleading information, about the Society's solvency position and its record of compliance with other regulatory requirements, that was produced by the FSA, acting on behalf of the prudential regulators, during the period after the Society closed to new business, constitutes maladministration. I therefore make such a finding of maladministration against the FSA."

There is a more detailed summary of the matters found to constitute this maladministration at 1/10/615-698 (pages 300-310).

- 2.15 On the basis that the Ombudsman's remit ran only to events prior to 1 December 2001, I take the provisional view that I must disregard any Findings relating to the FSA's assessment of Equitable Life's compromise proposal that was published on 7 December 2001.

The Ombudsman's Finding of injustice

- 2.16 The Ombudsman's Finding of injustice is at 1/12/168 (page 353):

"I find that injustice resulted from maladministration to all those who can show that they relied on misleading information provided by the FSA, that such reliance was reasonable in the circumstances, and that it led to a financial or other loss.

Where all this cannot be shown, I find that no injustice resulted from this maladministration."

That paragraph must be read with 1/12/167 (page 353).

"I consider that, in order to have sustained injustice as a result of this maladministration, those who acted in reliance on the information they received from the FSA and who suffered either a financial loss or a lost opportunity need also to show that such reliance was reasonable in the circumstances. That can only be determined at an individual level."

The Report contains a more detailed summary of the matters that have been found to constitute this injustice at 1/12/157-166 (pages 352-353), with further elaboration of the consequences of this act of maladministration at 1/12/56-58 (page 341) and of the general consequences of all the Ombudsman's Findings of maladministration taken together at 1/12/59-81 (pages 341-344).

The Government's response

- 2.17 The Government's acceptance of this Finding of maladministration leading to injustice is stated at Response paragraph 4.177-178, with elaboration at paragraphs 4.179-185 (pages 37-39):

"4.177 The Government accepts the Ombudsman's finding of maladministration on the basis set out below.

4.178 The Government accepts the finding of injustice, and considers that the Ombudsman's proposal that injustice suffered by policyholders be looked at on an individual basis is the only way losses attributable to this finding could reasonably be assessed"

Maladministration

"4.179 The Government accepts the Ombudsman's finding of maladministration, since it is accepted that the statement made in October 2001, namely that Equitable Life remained solvent, but continued to face fundamental uncertainties following the House of Lords' judgment in Hyman, had the potential to mislead policyholders and others reading it. Greater thought should have been given to making it clear that there had been a change in the FSA's understanding of Equitable Life's state of financial health so that policyholders and others could easily understand the difference between its statement that Equitable Life met "regulatory solvency margin requirements" (made in August 2001) and its statement that Equitable Life was "solvent" (made in October 2001). Furthermore, the FSA should have given further thought to its statement that Equitable continued to meet its regulatory solvency requirements in light of the specific failures on the part of Equitable Life which were known to the FSA."

Injustice

"4.180 The Government accepts the finding of injustice. However, the Government considers it necessary to explain the basis on which it does so. In particular, in considering the consequences of the maladministration identified by the Ombudsman, it is relevant to have regard to what was publicly known of Equitable Life's difficulties at the time the FSA made its statements.

4.181 *The account of various remarks by officials of the FSA given in the Report does not, in the Government's view, support the Ombudsman's conclusion that the FSA had no sound basis whatsoever for stating that Equitable Life was solvent.*

4.182 *Alongside the FSA's continual questioning of the position, there were at least three occasions during the period in question when the FSA took additional steps to satisfy itself as to Equitable Life's financial health:*

- *in late July 2001, there was extensive consideration of whether Equitable Life would require a waiver from solvency margin requirements in order to make an interest payment on its subordinated loan;*
- *in July 2001, the FSA required Equitable Life to commission an independent report on its solvency position;*
- *in October 2001, following disclosure of the side letter to the reinsurance treaty (which had previously been withheld from the regulator by Equitable Life), the FSA required Equitable Life to put in place a plan to restore its financial position.*

4.183 *Following the closure of Equitable Life to new business, the FSA received an exceptionally large volume of enquiries from MPs, the media and consumers requesting information and advice. Some consumers believed that they had lost the entire value of their policies. The FSA also became aware that a number of Independent Financial Advisers were encouraging customers to switch their policies away from Equitable Life, and was concerned that such advice may have been influenced inappropriately by commission considerations. It was in this context that the FSA decided to communicate, and determined the content of its communications.*

4.184 *The context in which the FSA's statements were made is important to understanding properly what policyholders and others could reasonably have taken from them. Although the public statements always reflected the FSA's considered view that Equitable Life remained solvent, no reader of the FSA's public communications could fairly have concluded that they provided "unqualified assurances" about Equitable Life's financial health and prospects.*

4.185 *Throughout this period, the media and industry commentators were aware that Equitable Life faced significant exposure as a result of its GAR contracts and the judgment of the House of Lords in Hyman. The information provided by the FSA formed only one part of the highly complex picture of Equitable Life's financial state."*

- 2.18 Again, as it seems to me, the effect of my Terms of Reference is that those paragraphs of the Response qualify the extent to which I am obliged and permitted to take the Ombudsman's Findings of injustice into account in determining the extent of relative losses suffered by classes of policyholders in respect of the Tenth Finding.

3 SUMMARY OF APPROACH

3.1 In principle, as it seems to me, each of the Fourth and Sixth Findings could give rise to two distinct heads of relative loss:

- (i) **Head A:** loss suffered as a result of decisions which policyholders would not have taken had they not been misled as a result of maladministration. These include decisions to take out Equitable Life policies, to pay non-obligatory premiums under existing policies, to take annuities with Equitable Life and not to require a transfer of funds to another pension provider; and
- (ii) **Head B:** loss suffered as a result of the weakened financial position of Equitable Life because it did not take steps that it would have taken had regulatory intervention been threatened or made.

Relative Loss under the Tenth Finding can only arise under Head A; Head B can have no application to loss under this Finding.

3.2 These two heads reflect different concepts:

- (i) Head A measures the relative loss suffered by those who put new money into Equitable Life (or did not withdraw funds from Equitable Life when they could have done so) by reference to the difference between the position in which they are (or were at the relevant end date) and the position in which they would have been if they had invested their money elsewhere in the market; and
- (ii) Head B measures the relative loss suffered by those who remained in Equitable Life (or continue to make payments) by reference to the difference between the position in which they are (or were at the relevant end date) and the position in which they would have been as Equitable Life policyholders had Equitable Life been properly regulated.

3.3 It is important to have in mind that relative loss measured under Head B would include loss suffered by those who remained in Equitable Life in circumstances in which, at the relevant time, they had no choice. At first sight, that would include loss suffered by:

- (i) with-profits annuitants;
- (ii) holders of recurrent single premium policies with no or no effective right to terminate; and
- (iii) those who were not effectively entitled to withdraw funds.

Loss measured under Head A would not include loss suffered by those who paid recurrent premiums under a contractual obligation or those who were not entitled to withdraw funds.

3.4 Nevertheless, it seems to me that, at least in respect of the Fourth Finding – and possibly also in respect of the Sixth Finding – I am precluded by the terms in which the Ombudsman has expressed her Findings of injustice from considering any loss falling under Head B. This is because the Ombudsman has found:

- (i) at Report 1/12/100 (page 346 and see paragraph 2.3 above), that no injustice resulted from maladministration under the Fourth Finding where a policyholder neither relied on

the information in the relevant regulatory returns nor suffered either a financial loss or a lost opportunity to take an informed decision as a result of such reliance; and

- (ii) at Report 1/12/146 (page 351 and see paragraph 2.10 above), that those who suffered injustice resulting from maladministration under the Sixth Finding were those (and, it would seem, only those) who joined Equitable Life or paid a further premium that was not contractually required in the period after 1 May 1999.

Given that the Terms of Reference require me to limit my considerations to those Findings that have been made by the Ombudsman and accepted by the Government, it seems to me that I am not permitted to consider any loss beyond that which the Ombudsman has found to have constituted injustice. I invite representations on this view.

3.5 Whether or not that provisional view is correct, it will be necessary to identify:

- (i) those who were policyholders at each relevant date;
- (ii) which of those policyholders had no practical choice but to remain in Equitable Life (or to continue to make payments); and
- (iii) which of those policyholders who, having a choice, made further premium or other payments or chose not to transfer funds out of Equitable Life.

3.6 Any individual policyholder may have suffered relative loss as a result of more than one act of maladministration. In so far as it is relevant to consider loss under Head B, individual policyholders may have suffered loss under both Head A (in respect of non-obligatory premium payments and in respect of decisions not to withdraw) and under Head B (in that, in the events which happened, they remained in Equitable Life). It is important to keep in mind the need to avoid a determination of relative loss which would give rise to an element of double counting. My provisional view is that (in so far as it is relevant to consider loss under Head B) policyholders should have their relative loss measured on the basis that is most advantageous to them. I invite representations on this view.

3.7 With these general considerations in mind, I see it as necessary:

- (i) to identify each distinct incident of maladministration (including the date or dates at which it occurred) within the Findings made;
- (ii) to consider what might have been expected to happen had that incident not occurred;
- (iii) to identify the classes of policyholders affected by each incident of maladministration and the manner in which they were so affected; and
- (iv) to measure the extent of relative loss (having regard to the considerations already mentioned) which each class of policyholders affected by the relevant incident can be said to have suffered.

3.8 My Terms of Reference underline the need for an expeditious process, I am very conscious of policyholders' desire for a swift a resolution to this matter. There are at least two ways in which this need for an expeditious process will affect my approach:

- (i) first, I would seek to avoid a requirement that individual policyholders prove the basis on which they made decisions to invest or stay in Equitable Life many years ago. After

so much time has elapsed, it is hard to see how such questions could be determined fairly. It is currently my intention to present my Advice to the Government accordingly; and

(ii) secondly, I would seek, so far as possible, to avoid making any new criticisms in my Advice of persons who were at relevant times involved with Equitable Life. I would hope in this way to avoid the need for any form of 'maxwellisation', which could result in substantial delay.

3.9 The questions set out below do not address directly the issue of which classes of policyholders have suffered "disproportionate impact". However, it may be that in the course of investigating the questions that do need to be examined it will become apparent that particular incidents of maladministration have affected certain classes of policyholders disproportionately. In particular, it appears to me to be a tenable view that one consequence of the way Equitable Life was managed in earlier years was that some policyholders received excessive reversionary benefits during the 1980s and early 1990s. If that is a correct view, then it may be appropriate for the Government to take these benefits into account when determining the amount that should be paid to any individual policyholder under an ex gratia payment scheme.

3.10 I am satisfied that the Terms of Reference do not require me to engage in any form of means-testing in relation to individual policyholders. I do not intend to do so. I note that this view reflects that of the Government; as appears from the evidence given by the Economic Secretary to the Treasury to the House of Commons Public Administration Select Committee on 11 February 2009.

4 ISSUES TO CONSIDER REGARDING RELATIVE LOSS

- 4.1 By reference to what end date should relative losses be assessed?
- 4.2 In respect of assessment of relative loss under Head A:
- (i) What was the policyholder's position at the end date, with reference to:
 - (a) the size of the fund available to the policyholder; and
 - (b) any sums received by way of an annuity or other payment out of the fund?
 - (ii) What would have been the policyholder's position at the end date if, instead of investing in Equitable Life, the policyholder had invested the same amount in a comparable product offered by another life assurance or pensions provider?
- 4.3 What provision, if any, should be made in respect of the following classes of policyholders:
- (i) policyholders who have died;
 - (ii) policyholders who have surrendered a policy; and
 - (iii) policyholders whose policy has been transferred to another life assurance or pensions provider?
- Should the treatment of such policyholders differ as between policies in different classes?
- 4.4 In respect of each relevant policy, how is a comparable product to be identified? In particular, should regard be had to:
- (i) a basket of comparable products offered by other life assurance or pensions providers; or
 - (ii) the product whose terms were the most similar to those being offered by Equitable Life?
- 4.5 In respect of those classes of policyholders whose relative loss falls to be assessed under Head B (in so far as it is relevant to consider loss under Head B), and in respect of funds that have been reduced since Equitable Life's closure to new business, what would have been the size of the fund if there had been no relevant maladministration?
- 4.6 What subsequent steps taken by policyholders should be taken into account in assessing relative losses? In particular, should regard be had to:
- (i) the surrender of an Equitable Life policy and withdrawal of a fund with penalties;
 - (ii) the transfer of a fund from Equitable Life to another life assurance or pensions providers; and
 - (iii) the conversion of an Equitable Life policy fund into an Equitable Life annuity?
- 4.7 To what extent should relative losses be netted off against relative gains (if any) that have accrued as a result of the accepted instances of maladministration? If gains should be netted off against losses, should that extend to gains and losses accrued in respect of different policies held by the same policyholder?

- 4.8 To what extent have those policyholders who have suffered relative loss already been compensated by other parties, including, in particular, compensation for mis-selling or other wrongs received from Equitable Life itself?
- 4.9 In so far as it is relevant to consider loss under Head B:
- (i) how should double counting in the assessment of relative loss under Head A and Head B be avoided; and
 - (ii) how should policyholders whose relative loss falls under both Head A and Head B be given the benefit of the most advantageous computation of relative loss?
- 4.10 How far, consistent with fairness, can the calculation of relative loss be simplified with a view to expediting payments?

5 ISSUES TO CONSIDER UNDER THE FOURTH FINDING

Maladministration

- 5.1 What questions (if any) should GAD have raised in respect of the retirement age assumptions in each of the 1994, 1995 and 1996 returns and when should it have done so? In particular, should GAD have raised questions as to:
- (i) whether the actual assumption made was prudent in the light of emerging experience; and
 - (ii) if so, what reason led to the change from the assumption used in earlier years?
- 5.2 If GAD had raised those questions that it should have raised concerning the retirement age assumptions, then in respect of each relevant set of returns:
- (i) What justification (if any) would Equitable Life have been able to provide for the changes from its assumption made in earlier years?
 - (ii) If so, by what date would this justification have been provided?
 - (iii) Would GAD have been acting reasonably if it had accepted that justification?
- 5.3 In respect of the 1994 return:
- (i) If Equitable Life's justification for the change in its retirement age assumption had not satisfied GAD (acting reasonably), was the effect of the change in the age assumption so material that GAD should have insisted that Equitable Life amend the relevant sections of the return?
 - (ii) If so, what amendment or amendments would Equitable Life have made and when would it have done so?
- 5.4 If GAD had raised the questions that it should have raised regarding the retirement age assumption in the 1994 return and whatever the outcome in relation to that return, would Equitable Life have submitted returns for 1995 and/or 1996 that differed materially from those which it actually submitted? If so, in what respects would those returns have differed?
- 5.5 In respect of the 1995 return:
- (i) What amendments (if any) should GAD/DTI have insisted that Equitable Life make in respect of (a) its retirement age assumption and/or (b) reserves for GARs? What constraint (if any) does Response paragraph 4.106 impose on the answer to this question in respect of GARs?
 - (ii) By what date should GAD/DTI have ensured that such amendments were made? Does the answer to this question differ in respect of amendments regarding (a) retirement age assumptions and (b) reserves for GARs?
- 5.6 If GAD had raised the questions that it should have raised in respect of retirement age assumptions and reserves for GAR liabilities in relation to the 1995 return and whatever the outcome in relation to that return, would Equitable Life have submitted a return for 1996 that

differed materially from that which it actually submitted? If so, in what respects would that return have differed?

5.7 In respect of the 1996 return:

- (i) What amendments should GAD/DTI have ensured that Equitable Life make in respect of (a) its retirement age assumptions and/or (b) reserves for GARs?
- (ii) By what date should GAD/DTI have ensured that such amendments be made? Is the answer to this question different for amendments in respect of (a) retirement age assumptions and (b) GARs?

Relative loss

Loss under Head A

5.8 How (if at all) would the information contained in the regulatory returns or revised regulatory returns have come to the attention of policyholders? In particular, should regard be had to:

- (i) the possibility (however remote) that individual policyholders would themselves examine and review regulatory returns;
- (ii) reporting in the financial press;
- (iii) information published in with-profits guides;
- (iv) figures provided by Equitable Life in marketing and reporting documentation;
- (v) reviews by other life assurance companies; and/or
- (vi) information published by rating agencies.

5.9 If Equitable Life had published different or revised regulatory returns would whatever information that policyholders (other than those who themselves examined and reviewed those returns) would have received, have differed from that which they did actually receive? If so, in what respects?

5.10 In respect of each of the 1994, 1995 and 1996 returns, to what extent would the publication of different or revised returns have made a material difference to policyholders' perception of Equitable Life in comparison with other life offices participating in the same market at that time?

5.11 Which classes of policyholders would have been in a position to take steps in direct or indirect reliance on the regulatory returns?

5.12 What matters would have influenced the decisions of those policyholders who were able to take steps in direct or indirect reliance on the regulatory returns? In particular, to what extent would policyholders have been influenced by:

- (i) penalties (if any) payable for withdrawing funds or ceasing to make contributions; and/or
- (ii) the tax treatment of any steps taken at that stage?

- 5.13 Is it possible to identify classes of policyholders for whom, on the basis of information published in revised regulatory returns, it would have been:
- (i) obviously advantageous to invest in a comparative product offered by a life assurance or pensions provider other than Equitable Life or to move funds away from Equitable Life; and
 - (ii) obviously not advantageous to invest other than with Equitable Life or to move funds away from Equitable Life?

On what basis should the relative loss suffered by those classes of policyholders who do not fall into either category be assessed?

Loss under Head B

[In so far as it is relevant to consider loss under Head B, consistently with the Ombudsman's Findings and the Terms of Reference (see paragraph 3.4 above)]

- 5.14 In respect of each of the 1994, 1995 and 1996 returns, given the extent of the amendments required, what options would have been open to GAD /DTI if Equitable Life had refused to revise its regulatory returns as required by GAD/DTI?
- 5.15 What might Equitable Life have been expected to do if the DTI had threatened regulatory intervention following scrutiny of the returns for each of years 1994, 1995 and 1996?
- (i) Would Equitable Life have changed its approach to the conduct of its business? In particular, would it have taken any of the following steps (individually or in combination):
 - (a) taken out reinsurance and if so on what terms;
 - (b) declared different bonuses and if so what;
 - (c) taken credit for a larger future profits implicit item and if so in what sum;
 - (d) adopted a different investment strategy; and/or
 - (e) started a new bonus series for new premiums, including new premiums on existing policies with GARs, subject to any constraints imposed by policy conditions?
 - (ii) Alternatively, would Equitable Life have chosen to leave the DTI with no alternative but to make a regulatory intervention?
- 5.16 If Equitable Life had left the DTI with no alternative but to make a regulatory intervention:
- (i) What form would that intervention have taken?
 - (ii) What consequences would have followed for existing policyholders? In particular:
 - (a) Would Equitable Life have been forced to close to new business earlier than it actually did? If so, when would it have closed to new business?
 - (b) Would Equitable Life have sought another commercial solution; and if so what solution?

- (c) If Equitable Life would have been able to continue to write new business, would regulatory intervention nonetheless have had a material effect on existing policyholders'?

6 ISSUES TO CONSIDER UNDER THE SIXTH FINDING

Relative loss

Loss under Head A

- 6.1 What would Equitable Life have done if the regulator had declined to allow it to take credit for the reinsurance treaty in its regulatory returns for 1998, 1999 and 2000? In particular, would Equitable Life have published different regulatory returns for 1998, 1999 and/or 2000 (including publishing returns with adjusted margins and/or increased use of the future profits implicit item)?
- 6.2 In assessing the financial position that would have been shown in the 1998 returns had no credit been taken for the reinsurance treaty, is it appropriate to take account of provisions (if any) in respect of GARs and any more prudent assumption as to retirement ages that should have been made in earlier returns – and in particular in the 1996 return?
- 6.3 If Equitable Life had not been permitted to take account of the reinsurance treaty in its 1998 return and if no other adjustments had been made, what would its published solvency position have been?
- 6.4 How (if at all) would the information contained in the regulatory returns have come to the attention of policyholders? In particular, should regard be had to:
 - (i) the possibility (however remote) that individual policyholders would themselves examine and review regulatory returns;
 - (ii) reporting in the financial press;
 - (iii) information published in with-profits guides;
 - (iv) figures provided by Equitable Life in marketing and reporting documentation;
 - (v) reviews by other life assurance companies; and
 - (vi) information published by rating agencies.
- 6.5 If Equitable Life had published different regulatory returns would whatever information that policyholders (other than those who themselves examined and reviewed those returns) would have received, have differed from that which they did actually receive? If so, in what respects?
- 6.6 To what extent would the publication of different regulatory returns have made a material difference to policyholders' perception of Equitable Life in comparison with other life offices participating in the same market at that time?
- 6.7 Which classes of policyholders would have been in a position to take steps in direct or indirect reliance on the regulatory returns?
- 6.8 What matters would have influenced the decisions of those policyholders who were able to take steps in direct or indirect reliance on the regulatory returns? In particular, to what extent would policyholders have been influenced by:

- (i) penalties (if any) payable for withdrawing funds or ceasing to make contributions; and/or
- (ii) tax treatment of any steps taken at that stage?

6.9 Is it possible to identify classes of policyholders for whom, on the basis of information published in revised regulatory returns, it would have been:

- (i) obviously advantageous to invest in a comparative product offered by a life assurance or pensions provider other than Equitable Life or to move funds away from Equitable Life; and
- (ii) obviously not advantageous to invest other than with Equitable Life or to move funds away from Equitable Life?

On what basis should the relative loss suffered by those classes of policyholders who do not fall into either category be assessed?

Relative loss under Head B

[In so far as it is relevant to consider loss under Head B, consistently with the Ombudsman's Findings and the Terms of Reference (see paragraph 3.4 above)]

6.10 What would Equitable Life have done if the regulator had declined to allow it to take credit for the reinsurance treaty in its regulatory returns for 1998, 1999 and/or 2000? Specifically, would Equitable Life have changed its approach to the conduct of its business? In particular, would it have taken any of the following steps (individually or in combination):

- (i) renegotiated the terms of the reinsurance treaty with IRECO;
- (ii) taken out alternative reinsurance cover (in which case, what alternative cover would have been permissible, and what impact would such a reinsurance treaty have had on the financial position of Equitable);
- (iii) declared different bonuses and if so what;
- (iv) taken credit for a larger future profits implicit item into account and if so in what sum;
- (v) adopted a different investment strategy (including by reducing some of its equity exposure in favour of fixed interest assets);
- (vi) applied market value adjusters; and/or
- (vii) started a new bonus series for new premiums, including new premiums on existing policies with GARs, subject to any constraints imposed by policy conditions?

6.11 If Equitable Life had not been permitted to take account of the reinsurance treaty in its 1998 return and if no other adjustments were made:

- (i) Would Equitable Life have been able to declare (a) the bonus and (b) the increase in policy values that it in fact declared?
- (ii) If not, (a) what bonus and (b) what increase in policy values would Equitable Life have in fact declared?

- 6.12 If Equitable Life had left the regulator with no alternative but to make a regulatory intervention:
- (i) What form would that intervention have taken?
 - (ii) What consequences would have followed for existing policyholders? In particular:
 - (a) Would Equitable Life have been forced to close to new business earlier than it actually did?
 - (b) Would Equitable Life have sought another commercial solution and if so what solution?
 - (c) If Equitable Life would have been able to continue to write new business, would regulatory intervention nonetheless have had a material effect on existing policyholders'?

7 ISSUES TO CONSIDER UNDER THE TENTH FINDING

7.1 On the basis that:

- (i) the Ombudsman found at Report 1/12/167-168 (page 353) that no injustice resulted in cases where it could not be shown that a policyholder relied on misleading information provided by the FSA; that such reliance was reasonable in the circumstances; and that that could only be determined on an individual level; and
- (ii) the Government accepted at Response paragraph 4.178 (page 37) that the only way in which losses attributable to the Tenth Finding could be assessed was by looking at policyholders on an individual basis,

how can the extent of relative losses under the Tenth Finding be assessed consistently with the need to avoid imposing unrealistic burdens on claimants? Is there any alternative to requiring individuals to come forward and prove their cases?

- ### 7.2
- If it is permissible to assess loss on an alternative basis, what assumptions (if any) should be made as to policyholders' reliance on material published by the FSA and the reasonableness of such reliance?