

# **The Prudential Regulation of the Equitable Life Assurance Society:**

the Government's response to  
the Report of the Parliamentary  
Ombudsman's Investigation

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January 2009







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# The Prudential Regulation of the Equitable Life Assurance Society: the Government's Response to the Report of the Parliamentary Ombudsman's Investigation

Presented to Parliament by the  
Chief Secretary to the Treasury  
by Command of Her Majesty

January 2009

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# Executive summary

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The Government has carefully considered the Parliamentary Ombudsman's substantial Report into the prudential regulation of the Equitable Life Assurance Society from 1988 to 1 December 2001, under a previous regulatory regime.

The Government accepts that certain maladministration occurred and that, in some cases, this caused an injustice to some Equitable Life policyholders.

On behalf of the public bodies and successive Governments responsible for the prudential regulation of Equitable Life between 1990 and 2001, the Government apologises to Equitable Life policyholders, many of whom have suffered significant distress as a result of the events at Equitable Life, for the maladministration accepted by the Government.

The Government will take action to establish a fair ex gratia payment scheme for those Equitable Life policyholders who have suffered a disproportionate impact as a result of the relevant maladministration, although it does not accept that it would be appropriate to provide compensation in the way suggested by the Parliamentary Ombudsman.

The Government has invited the Rt Hon Sir John Chadwick to advise the Government on the matters relevant to disproportionate impact suffered by current and former Equitable Life policyholders.

Although the Parliamentary Ombudsman was unable to consider the conduct of Equitable Life or any other parties involved in Equitable Life's difficulties as part of her extensive investigation, such matters are relevant to the design of the payment scheme.

Lord Penrose's independent forensic investigation into the events at Equitable Life concluded that the Society was "*principally ... [the] author of its own misfortunes*". The Public Administration Select Committee noted in their report published in December 2008 that "The current board of Equitable Life and many others have acknowledged the legitimacy of Lord Penrose's conclusion; few people dispute that its former management were primarily to blame."

Sir John has therefore been asked to advise on an appropriate apportionment of losses between the public bodies investigated by the Ombudsman and the actions of Equitable Life and other parties.

With the benefit of Sir John's advice, and taking account of the position of the public finances and the need to ensure practicality of delivery, the Government will introduce a fair ex gratia payment scheme.





# 1

## Introduction

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**1.1** The Parliamentary Ombudsman (“the Ombudsman”) published the report of her second investigation into the prudential regulation of the Equitable Life Assurance Society (“Equitable Life”) on 17 July 2008. The Ombudsman’s investigation, which was launched in 2004, focussed principally on the events leading up to Equitable Life’s decision to close to new business in December 2000.

**1.2** The Ombudsman’s report considered the actions of the prudential regulator over this period (sequentially the Department of Trade and Industry, HM Treasury and the Financial Services Authority acting as agent on HM Treasury’s behalf) and those of the regulator’s actuarial adviser, the Government Actuary’s Department (“GAD”).

**1.3** GAD’s actions in relation to the prudential regulation of insurance companies in the period prior to 26 April 2001 were brought within the Ombudsman’s jurisdiction, at her request, to facilitate the investigation.

**1.4** The Ombudsman did not consider the actions of Equitable Life, or indeed other parties, as it was not within her jurisdiction to do so. The Ombudsman explicitly states in her Report that “It has been no part of my investigation to attempt to make findings about the actions of the Society” and that her Report “does not seek to explain what caused the ‘difficulties’ of the Society”.

**1.5** The terms of reference for the investigation were:

*To determine whether individuals were caused an injustice through maladministration in the period prior to December 2001 on the part of the public bodies responsible for the prudential regulation of the Equitable Life Assurance Society and/or the Government Actuary’s Department; and to recommend appropriate redress for any injustice so caused.*

**1.6** A number of complaints stood behind those terms of reference. The general complaint made was that the public bodies responsible for the prudential regulation of insurance companies and the regulator’s actuarial adviser (those bodies listed in paragraph 1.2 above) failed for considerably longer than a decade properly to exercise their regulatory functions in respect of Equitable Life and were therefore guilty of maladministration.

**1.7** Eighteen detailed complaints were also made. These raised issues relating to the operation of the regulatory system, the resources and capability of the regulators, the supervision of Equitable Life’s solvency, and the protection of policyholders’ reasonable expectations.

**1.8** The Ombudsman is independent of government and has statutory responsibilities and powers to report directly to Parliament. She must assess the actions of the bodies she

investigates against the standards prevailing at the time and the information then available to the relevant bodies. She cannot use the benefit of hindsight.

## The Ombudsman's findings

**1.9** The Ombudsman made 10 findings of maladministration, and upheld the general complaint that there was regulatory failure for more than a decade in the period before Equitable Life closed to new business in December 2000. Based on her findings of maladministration, the Ombudsman also made five findings of injustice, including three findings of financial loss and/or lost opportunities, one finding of lost opportunities, and one finding of outrage. Her central recommendation was that the Government should establish and fund a compensation scheme with the aim of restoring those who suffered a relative loss (i.e., a loss which policyholders would not otherwise have suffered had they invested or saved elsewhere than Equitable Life) to the position in which they would have been had the maladministration she found not occurred.

**1.10** The Ombudsman commented that the findings in the report should not be taken as being based on a view that the prudential regulator and GAD were in any sense guilty of acting in bad faith.

**1.11** The Government has considered the Ombudsman's report carefully. The purpose of this document is to respond to the Parliamentary Ombudsman's findings and recommendations. It necessarily does so in the context of the Insurance Companies Act 1982 regime which applied during the period investigated by the Ombudsman.

**1.12** The 1982 Act regime (described in Chapter 3 of this paper) was reactive and unintrusive. It was based on regulatory returns submitted by insurance companies and placed considerable reliance on the Appointed Actuary. The prudential regulator was not required to second-guess those commercial decisions which were properly for the boards of insurance companies.

**1.13** Lord Penrose was critical of the 1982 Act regime, which he said "failed to provide the regulation that changing circumstances in the industry required". The prudential regulatory regime has been substantially reformed since the period considered by the Ombudsman. These reforms were described by Lord Penrose as "a major, comprehensive reassessment of the requirements of an efficient regulatory system for insurance sector".

**1.14** The Government's response to the Ombudsman's findings and her recommendations in no way implies that Equitable Life was without fault. The Government reserves the right to make representations on this issue during the Rt Hon Sir John Chadwick's consideration of matters relevant to disproportionate impact suffered by current and former Equitable Life policyholders.

**1.15** The following Chapters provide:

- a brief summary of the events leading to Equitable Life's decision to close to new business in December 2000;
- an outline of the prudential regulatory regime for insurance companies that had been put in place by Parliament;
- the Government's response to the Ombudsman's individual findings; and
- the Government's response to the Ombudsman's recommendations.

# 2

## Events at Equitable Life

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**2.1** Equitable Life is a mutual insurance company owned by its policyholder members.

**2.2** The Ombudsman's investigation focussed on the 'with-profits' life assurance policies written by Equitable Life. These policies are typically used as a means of accumulating a fund to purchase an annuity in order to provide a pension in retirement. Equitable Life also wrote annuities in with-profits form.

**2.3** From the late-1950s until June 1988 Equitable Life sold significant volumes of with-profits policies which included a Guaranteed Annuity Rate ("GAR"). These policies provided a fixed rate at which the policyholder was entitled to purchase an annuity on the maturity of his/her policy. After this date, policies were sold without the GAR.

**2.4** The value of both types of policy was increased by bonuses declared by Equitable Life. There were two categories of bonus:

- a 'reversionary' bonus which was declared regularly and once allocated to the policy formed part of the guaranteed element (as long as the policy was held to maturity); and
- a 'terminal' (or 'final') bonus which was determined only when a claim was paid and was not guaranteed.

**2.5** During the 1990s, the GAR became increasingly attractive as the income that would be available from an annuity purchased in the market for the first time fell below the guaranteed rate, with resulting financial implications for Equitable Life.

**2.6** Equitable Life responded by equalising annuity rates across all classes of policyholder by paying a lower terminal bonus to those who exercised the GAR option. In July 2000, the House of Lords ruled in the *Hyman* case ([2002] 1 AC 408) that this was an unlawful variation of contractual terms, forcing Equitable Life to pay the same terminal bonus to all with-profits policyholders.

**2.7** Equitable Life had a well-publicised but highly unusual policy of distributing a large proportion of profits to with-profits policyholders. This meant that it held lower reserves in excess of statutory requirements than many of its competitors and consequently had fewer assets available to meet the estimated liability of £1.5 billion resulting from the *Hyman* judgment. In an attempt to secure a fresh injection of capital, Equitable Life put itself up for sale. When no buyer could be found, Equitable Life announced its closure to new business on 8 December 2000.

### Inquiries and Investigations

**2.8** A number of inquiries and investigations have been carried out since Equitable Life's decision to close to new business:

- the Treasury Select Committee published an interim report in March 2001 (Tenth Report, 2000-2001 Session);
- the Financial Services Authority carried out a review of the regulation of Equitable Life from 1 January 1999 to 8 December 2000 (HC 244, published on 16 October 2001);
- the Ombudsman carried out an investigation into the prudential regulation of Equitable Life in the period 1999 to 2001 (HC 809, published 1 July 2003): no maladministration was found; and
- at the request of the then Financial Secretary to the Treasury, Lord Penrose "... enquire[d] into the circumstances leading to the current situation of the Equitable Life Assurance Society, taking account of relevant life market background; to identify any lessons to be learnt for the conduct, administration and regulation of life assurance business..." (HC 290, published 8 March 2004).

**2.9** The central finding of Lord Penrose's report was that Equitable Life was "*principally... [the] author of its own misfortunes*". He was also critical of the regulatory system but found that this was a secondary factor.

**2.10** The Government recognised the deficiencies in the regulatory system in 1997 and took steps to establish the Financial Services Authority ("the FSA") as the single financial services regulator with a set of clear objectives, which were contained in the Financial Services and Markets Act 2000.

**2.11** The Ombudsman announced her decision to conduct a second investigation into the prudential regulation of Equitable Life in 2004 (HC 910, published 19 July 2004) subject to the Government extending the Ombudsman's jurisdiction to allow her to consider the actions of GAD. The Government agreed to the Ombudsman's request and her jurisdiction was extended by Parliament on 15 November 2004.

# 3

## The prudential regulatory regime

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**3.1** Until December 2001, when the Financial Services and Markets Act 2000 (FSMA) came into force, life insurance companies were subject to two regulatory regimes: prudential regulation and conduct of business regulation.

**3.2** Prudential regulation was concerned with the solvency of insurance companies, and the soundness and prudence of their management. Conduct of business regulation related primarily to the marketing and sale of a company's products and the provision of related advice to current and potential policyholders.

**3.3** The Ombudsman's investigation considered the application of the regime for the prudential regulation of life insurance companies in the Insurance Companies Act 1982 by those bodies charged with that function. Conduct of business regulation does not fall within the Ombudsman's jurisdiction.

**3.4** The deficiencies in the 1982 Act regime, which was reactive and unintrusive, were recognised by the Government. The FSA was established with a clear set of statutory objectives. Following the coming into force of FSMA in December 2001, the FSA introduced a series of reforms focussed on insurance supervisory policies and practices. Lord Penrose, who was critical of the former regulatory regime, welcomed these reforms, saying that the FSA "has sought to anticipate many of the lessons that might be drawn by this inquiry, and it should come as no surprise that it has largely succeeded in that".

**3.5** The Ombudsman's Report must therefore be seen in the context of the prudential regulatory regime in place at the time. It is necessary to understand both the nature of that regime and the role of those charged with its implementation. Throughout this document, references to the regulator are to be taken as references to the prudential regulator unless otherwise stated.

### Philosophy

**3.6** The philosophy which guided the prudential regulation of life insurance companies from its inception was "freedom with publicity". This sought to provide an appropriate balance between commercial freedom and innovation on the one hand and policyholder protection on the other. It left insurance companies free to design their own products and set premiums whilst requiring them to make their affairs public through financial information being placed in the public domain.

**3.7** Parliament concluded that the doctrine of "freedom with publicity" should continue when it passed the Insurance Companies (Amendment) Act 1973 and it remained a fundamental principle of prudential regulation under the Insurance Companies Act 1982. It was the latter Act which applied throughout the period investigated by the Ombudsman.

**3.8** Whilst the amount of financial information which was required to be disclosed by companies and considered by the regulator was gradually increased by various statutory instruments, it was always carefully circumscribed.

## **Role of the Appointed Actuary**

**3.9** The 1973 Act placed an increasing amount of reliance on insurance companies' actuaries through the introduction of the Appointed Actuary system. This approach was continued in the 1982 Act.

**3.10** The 1982 Act required the Appointed Actuary to conduct an annual investigation into the company's financial condition. The report of the investigation would normally be presented to the Board. The investigation was to include a valuation of liabilities of the company attributable to its life assurance business and a determination of any excess over those liabilities of the assets representing the fund or funds maintained by the company in respect of that business.

## **Regulatory returns**

**3.11** Section 22 of the 1982 Act required each life company to submit the abstract of the Appointed Actuary's valuation report ("the regulatory returns") to the regulator each year, along with the annual report and accounts required under the Companies Act.

**3.12** The regulatory returns were detailed and lengthy documents (during the latter half of the 1990s those for Equitable Life ran to some 400 pages each year) and the main source of information from which the regulator, acting on advice from GAD, formed a view as to a life insurance company's current and future regulatory solvency. The returns were filed at Companies House and hence were available to the public.

## **Intervention powers**

**3.13** The 1982 Act gave the regulator a number of intervention powers which, for the most part, were closely circumscribed. They included powers to:

- require a life insurance company not to make, or to realise, certain investments;
- limit the aggregate premium income of the company;
- require the Appointed Actuary to investigate all or a specified part of the company's business, and to publish an abstract of that investigation;
- accelerate the deposit of the regulatory returns with the regulator; to communicate with companies with a view to ensuring the accuracy of the returns; and to obtain information or require the production of documents.

**3.14** There was also a residual power which enabled the regulator to take such action as appeared appropriate for the purpose of protecting policyholders or potential policyholders of a life insurance company against the risk that the company might be unable to meet its liabilities, or to fulfil the reasonable expectations of policyholders or potential policyholders. Policyholders' reasonable expectations ("PRE", which term also includes the expectations of potential policyholders) was a term introduced in the 1973 Act. Though not specifically defined, the concept extended to the interests of policyholders beyond strict contractual entitlements, and the regulator could intervene if there were grounds to believe that PRE were not being met.

# 4

## The Government's response to the Ombudsman's findings

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**4.1** This Chapter sets out the Government's response to the Ombudsman's findings.

**4.2** As the Ombudsman herself observed, her investigation was not, nor could it have been given the inherent jurisdiction of the Ombudsman's office, focussed on the actions of the entity being regulated, nor of any other third parties. The Ombudsman explicitly states that she does not seek to explain what caused the "difficulties" of Equitable Life.

**4.3** This response is limited to the acts and omissions of the bodies forming the regulatory regime at the relevant time and does not extend to the responsibilities of Equitable Life itself, or of its advisors. Therefore, the Government's response to the Ombudsman's findings and recommendations in no way implies that Equitable Life or its advisors were without fault. The Government reserves the right to make representations on this issue at a later date.

**4.4** The Government's response to the Ombudsman's findings is as follows:

- Finding 1 (dual role) – finding of maladministration not accepted; no finding of injustice
- Finding 2 (scrutiny of Equitable Life's returns for 1990 – 1993)
  - Valuation interest rates – finding of maladministration accepted; finding of injustice not accepted
  - Affordability and sustainability of bonus declarations – finding of maladministration accepted; finding of injustice not accepted
- Finding 3 (differential terminal bonus policy) – finding of maladministration accepted in part, not accepted in part; finding of injustice not accepted
- Finding 4 (scrutiny of Equitable Life's returns for 1994 – 1996)
  - Valuation interest rates - finding of maladministration accepted; finding of injustice not accepted
  - Affordability and sustainability of bonus declarations – finding of maladministration accepted; finding of injustice not accepted
  - Reserves for prospective liabilities for tax on unrealised capital gains – finding of maladministration not accepted; finding of injustice not accepted
  - Reserves for liabilities for pensions mis-selling costs - finding of maladministration not accepted; finding of injustice not accepted
  - Changes to retirement ages - finding of maladministration accepted; finding of injustice accepted
  - Reserves for guaranteed annuity rates - finding of maladministration accepted; finding of injustice accepted

- Finding 5 (presentation of Equitable Life’s two valuation results) - finding of maladministration accepted in part, not accepted in part; finding of injustice not accepted
- Finding 6 (financial reinsurance) - finding of maladministration accepted; finding of injustice accepted
- Finding 7 (disclosure of potential impact of the *Hyman* litigation) - finding of maladministration accepted; no finding of injustice
- Finding 8 (recording the decision to allow Equitable Life to remain open) - finding of maladministration accepted; no finding of injustice
- Finding 9 (the basis for the decision to allow Equitable Life to remain open) - finding of maladministration accepted; no finding of injustice
- Finding 10 (information provided by the FSA in the post-closure period) - finding of maladministration accepted; finding of injustice accepted.

## **FINDING 1 – DUAL ROLE**

### **Summary of findings**

**4.5** The Ombudsman finds that the Department of Trade and Industry, as the regulator, failed a) to insist, when approving the appointment in June 1991 of a new Chief Executive, that he should demit office as Equitable Life’s Appointed Actuary and b) during the period from 1 July 1991 to 31 July 1997, when one person held both roles, to consider the use of its powers to seek to remove that person from such “dual role” (Chapter 10, paragraphs 40 to 131). She finds that, as a result, the Appointed Actuary lacked the necessary degree of independence from Equitable Life’s executive management (Chapter 11, paragraph 14).

**4.6** The Ombudsman has determined that these failures constitute maladministration (Chapter 11, paragraph 27) but was unable to determine whether injustice resulted, and no finding of injustice is made (Chapter 12, paragraphs 87 and 88).

### **Government’s response**

**4.7** The Government does not accept this finding of maladministration, the basis of which does not reflect the legal position applicable at the time.

**4.8** The Ombudsman makes no finding of injustice.

### **Maladministration**

**4.9** The Government does not accept the Ombudsman’s finding. At the time there was no legal basis for the regulator to exercise its powers under the relevant regulations either to refuse to approve the appointment of the existing Appointed Actuary to the post of Chief Executive or to seek to remove that person from such “dual role” in the circumstances of this case. Consequently, this was a matter for the management of the company and of itself could not have led to regulatory intervention.



**4.10** The Ombudsman suggests that the regulator directed itself to the question of whether it had power to object to the incumbent remaining as Appointed Actuary, and that this was the wrong question (Chapter 11, paragraph 23). She also criticises the regulator for failing to consider the use of any of its powers to bring the dual role to an end (Chapter 11, paragraph 24).

**4.11** The Government suggests that it appears from the sequence of events summarised at paragraphs 47 to 57 of Chapter 10 of the Ombudsman's Report that the regulator addressed the question of whether the appointment of the existing Appointed Actuary to the role of Chief Executive should be approved.

**4.12** Furthermore, there was no legal basis for withholding authorisation of the appointment of the Appointed Actuary as Chief Executive, and once authorisation was given there were no grounds upon which the Chief Executive could be removed; the regulator was therefore under no obligation to consider whether to seek his removal from that role.

**4.13** The four powers of intervention which the Ombudsman states the regulator should have considered are the following:

- An objection that the Appointed Actuary was not a fit and proper person to hold the post of Chief Executive simultaneously;
- An intervention under section 37(5) of the Insurance Companies Act 1982;
- From 1 July 1994, an objection under paragraph 4(1) of Schedule 2D to the Insurance Companies Act 1982 on the ground that the criteria of sound and prudent management were not being fulfilled –
  - i) on fit and proper person grounds;
  - ii) as the Company was not directed and managed by a sufficient number of fit and proper persons; and
  - iii) by reason of the ability of one person to influence the Company.
- The use of non-statutory action or professional influence, or an increased level of scrutiny of Equitable Life to mitigate the effect of the dual role.

**4.14** The Government's position in relation to each power is set out in turn below. Given the fact that the Government does not accept the options set out by the Ombudsman, the question of appointing one person to both roles within the Society was a matter entirely for Equitable Life's own management.

#### **Power to refuse appointment of a Chief Executive on fit and proper person grounds (Chapter 10, paragraph 81)**

**4.15** The Ombudsman makes no judgement about the Chief Executive's fitness and propriety per se (Chapter 10, paragraph 90), but states that her concerns relate to a wider matter of principle – namely that an Appointed Actuary was, by definition, not a fit and proper person to hold concurrently the position of Chief Executive (Chapter 10, paragraph 95).

**4.16** The Government suggests that, if correct, this would be equivalent to preventing the same individual from holding both roles, a bar which Parliament has not seen fit to introduce despite, for example, having introduced the bar in Section 27 of the Companies Act 1989 on officers or

employees of a company being appointed as company auditors, on the grounds of lack of independence.

#### **Power to intervene pursuant to Section 37(5) of the Insurance Companies Act 1982 (Chapter 10, paragraph 83)**

**4.17** The Ombudsman does not stipulate which of the powers of intervention specified in Section 37(5) (which itself refers to the powers in Sections 38, 41, 42, 44(1) and 45 of the same Act) the regulator should have exercised. However, only that in Section 45 - which gives the regulator the power to take such action as appears appropriate to protect against the risk of failing to meet liabilities or PRE and to ensure that the criteria of sound and prudent management are fulfilled – would appear to have the potential to apply here. Since the Ombudsman deals specifically with the criteria of sound and prudent management at paragraphs 84-87 of Chapter 10, the Government understands that the reference to Section 37(5) is intended to be a reference to the power to intervene on PRE grounds, and responds accordingly.

**4.18** The fact that protection of PRE was merely capable of being frustrated is not enough – the regulator would need to be of the opinion that PRE was at risk before intervening. PRE plainly did not create a bar to the two roles being held by the same person (in contrast to Section 27 of the Companies Act 1989, referred to above). Policyholders were well aware of the position, yet no objection was ever raised. There was no basis, therefore, for the regulator to conclude that the fact that the two roles were performed by the same person did put PRE at risk.

#### **Power to intervene (from 1 July 1994) if it appeared that the criteria of sound and prudent management were not being fulfilled**

**4.19** The Ombudsman deals in turn with a number of the criteria of sound and prudent management which might justify intervention. These are considered below.

##### *On fit and proper person grounds (Chapter 10, paragraph 85):*

**4.20** The Government repeats its comments on the fit and proper person test set out above.

##### *If the Company is not directed and managed by a sufficient number of fit and proper persons (Chapter 10, paragraph 86):*

**4.21** Paragraph 4 of Schedule 2A to the Insurance Companies Act 1982 did not require each role within an insurance company to be filled by a different person. It merely required that a company as a whole be managed and directed by a sufficient number of persons, each of whom was fit and proper, a requirement which, to the best of the regulator's belief at the time, was satisfied in Equitable Life's case.

**4.22** From the date the powers were introduced (1 July 1994) to the date the Chief Executive retired (1 August 1997), Equitable Life's board numbered between 11 and 15 individuals, each of whom to the best of the regulator's belief at the time satisfied the "fit and proper" test. Had the holder of the two roles relinquished one or other of the roles, this would have had no effect on the number of directors or managers of the company, according to the definitions of the words "director" and "manager". The term "manager" was defined in section 96D(1) of the Insurance Companies Act 1982, and explicitly excluded a Chief Executive. The term "director" had its common meaning under section 96(1) of the Insurance Companies Act 1982. The phrase

“directed and managed” in paragraph 4 of Schedule 2A fell to be interpreted according to those definitions.

*By reason of the ability of a person who is a controller of an insurance company to influence that company (Chapter 10, paragraph 87):*

**4.23** The regulator would have had to be satisfied that the criteria of sound and prudent management were actually at risk before taking action. The regulator was not aware, nor could it have been aware, of any grounds for reaching such a conclusion, and could not therefore have taken action on this ground. If the dual role had been causing any material concern as to the sound and prudent management of Equitable Life, the regulator would have been alert to the possibility of causing the holder of the dual role to relinquish the post of Chief Executive.

#### **Non-statutory intervention (Chapter 10, paragraphs 108 and 110)**

**4.24** The regulator (assisted by GAD) did bring pressure to bear in order to try to persuade Equitable Life to separate the roles. This was because, as is reflected in the Ombudsman’s account of events in Chapter 10 of the Report (and in particular paragraphs 48-59), it was not thought desirable for the same person to hold both roles due to the danger of control of Equitable Life becoming over-centralised. Such pressure was resisted by Equitable Life.

**4.25** The Government suggests that the regulator could take no further action; the regulator’s efforts were unsuccessful precisely because they could not be backed up with a statutory ground for intervention. In any event, Equitable Life was able to meet what appeared to be the regulator’s key concern, regarding centralisation of control (Chapter 10, paragraph 56).

**4.26** Any decision to conduct a more intensive scrutiny of Equitable Life on the grounds of the dual role would have been open to legal challenge by Equitable Life in the absence of statutory or regulatory justification.

#### **Injustice**

**4.27** The Government notes that the Ombudsman has said that she was unable to establish that the existence of the dual role resulted in any injustice to policyholders.

## **FINDING 2: SCRUTINY OF EQUITABLE LIFE’S REGULATORY RETURNS FOR 1990 – 1993**

### **Summary of findings**

**4.28** The Ombudsman finds that GAD failed to question and seek to resolve questions within Equitable Life’s regulatory returns for 1990 to 1993 related to a) the valuation rate of interest used to discount Equitable Life’s liabilities and b) the affordability and sustainability of Equitable Life’s bonus declarations (Chapter 10, paragraphs 132 to 202).

**4.29** The Ombudsman has determined that these failings constitute maladministration (Chapter 11, paragraph 40) and that, combined with Findings 4 and 5, injustice was sustained by any policyholder who relied on information in Equitable Life’s returns from 1990 to 1996 and who suffered either a financial loss or a loss of opportunity to take an informed decision as a result of such reliance (Chapter 12, paragraph 100).

## Government's response

**4.30** The Government accepts the finding of maladministration in respect of both a) the valuation rate of interest and b) the affordability and sustainability of Equitable Life's bonus declarations.

**4.31** However, the Government does not accept the Ombudsman's finding of injustice in either respect.

### Maladministration

#### Valuation interest rates

**4.32** The Government accepts that GAD did not raise any query based on Equitable Life's regulatory returns for 1990 as to Equitable Life's approach to valuation interest rates. The Government also accepts that it would have been appropriate for GAD, in the course of its review of Equitable Life's regulatory returns, to raise such a query given the level of Equitable Life's valuation interest rates. In relation to Equitable Life's returns for 1991 to 1993, GAD did seek further information as to Equitable Life's approach to valuation interest rates in correspondence. However, it is accepted that GAD did not satisfactorily resolve those issues.

#### Affordability and sustainability of Equitable Life's bonuses

**4.33** The Government accepts that GAD did not question Equitable Life and resolve concerns which it held internally about Equitable Life's ability to pay future bonuses in a way which did not adversely affect PRE. It is clear that GAD held concerns about Equitable Life's bonus policy and the Government agrees that it would have been appropriate for GAD to have raised these concerns with Equitable Life. It is therefore accepted that GAD did not satisfactorily resolve these issues.

### Injustice

#### Valuation interest rates

**4.34** The Government considers that the Ombudsman's Report provides no basis for the finding of injustice resulting from the failure to question and seek to resolve issues related to the valuation rate of interest used to discount Equitable Life's liabilities. In the Government's view, that finding does not consider whether the regulatory failure identified would or could have resulted in an injustice to those reading Equitable Life's regulatory returns. The Government has considered this issue and concluded that no injustice did arise.

**4.35** The Ombudsman's analysis does not demonstrate that Equitable Life's use of valuation interest rates failed to comply with the regulations applicable at the time. Indeed, the Ombudsman accepts that it may now be possible to show that Equitable Life was in fact acting appropriately as regards its approach to valuation interest rates (Chapter 10, paragraph 186). As a result, the Government does not share the view in the Ombudsman's report that the published information contained in Equitable Life's regulatory returns would have been different had GAD questioned Equitable Life's approach. Consequently, in the Government's view, no injustice to policyholders or others reading the regulatory returns can be said to have resulted from this aspect of the maladministration found by the Ombudsman.

**4.36** The Government has reviewed Equitable Life's approach to the issue of valuation interest rates and, for the reasons set out below, it is satisfied that Equitable Life was acting in a manner consistent with the applicable regulatory requirements.

#### *Valuation interest rates – 1990 and 1991 returns*

**4.37** The Ombudsman finds that in 1990 and 1991 "the current assets were of shorter duration than a significant proportion of the liabilities, which meant that those assets would have to be reinvested at some future date" (Chapter 10, paragraph 160).

**4.38** The approach adopted by Equitable Life in its 1990 and 1991 returns to the reinvestment of assets was consistent with the applicable regulations. Any contracts that had a valuation interest rate above the reinvestment yield (as described in regulation 59(7) of the Insurance Companies Regulations 1981) either had zero or negligible reinvestment risk. Therefore, it would not be unusual for the valuation interest rate on these contracts to exceed the reinvestment rate. The Ombudsman's finding is therefore without basis.

**4.39** As such, the Government considers that there is no sound basis for considering that an attempt by GAD to investigate this issue would have resulted in any changes to the contents of Equitable Life's regulatory returns in the relevant years. The Government therefore does not accept this part of the finding of injustice.

#### *Valuation interest rates – 1992 returns*

**4.40** The Ombudsman raises the issue on reinvestment, described above for the 1990 and 1991 returns, again for the 1992 returns. The same analysis as described above applies. Additionally, the Ombudsman finds that in Equitable Life's 1992 returns, "GAD did not identify that...the valuation rate used in relation to significant elements of [Equitable Life's] business appeared not to be supported by the backing assets" (Chapter 10, paragraph 164).

**4.41** In 1992 the overall yield on the assets backing the liabilities was greater than the weighted average of the interest rates used. Further analysis of the yields contained in the relevant part of Equitable Life's regulatory returns shows that the assets could be hypothecated (matched) to the liabilities to justify the interest rates used. To do this Equitable Life required a yield on equities of 4.35% per annum. Whilst the equity yield set out in Equitable Life's returns was 4% per annum, this difference is explicable because the 4% yield in the returns represented a weighted average of the individual equity holdings within the overall investment portfolio – some stocks would have been yielding above this figure and some below.

**4.42** Therefore, Equitable Life could have matched the liabilities with the highest yielding equities. If these higher yielding equities had an average yield of 4.35% per annum, the remaining lower yielding equities would have had an average yield of 3.4% per annum, which is well within the range of usual equity yields. The 4.35% per annum equity yield is therefore justifiable.

**4.43** As such, the Government does not share the Ombudsman's view that any attempt by GAD to investigate this issue would have resulted in changes to the content of Equitable Life's regulatory returns in the relevant years. The Government therefore does not accept this part of the finding of injustice.

### *Valuation interest rates – 1993 returns*

**4.44** The Ombudsman finds that in Equitable Life's 1993 returns, GAD had identified that "...the valuation interest rates that had been used by the Society seemed high compared to the available yields on assets shown in Form 45 of those returns" (Chapter 10, paragraph 166), but failed to resolve the issue.

**4.45** There was nothing in Equitable Life's 1993 regulatory returns (or in the Ombudsman's Report) to suggest that the interest rates used in 1993 did not comply with the regulations and were therefore not justifiable.

**4.46** As such, the Government considers that there is no sound basis for considering that any attempt by GAD to resolve this issue would have resulted in any changes to the content of Equitable Life's regulatory returns in the relevant years. The Government therefore does not accept this part of the finding of injustice.

### *Affordability and sustainability of Equitable Life's bonuses*

**4.47** The Ombudsman's Report does not properly explain the basis for a finding of injustice resulting from the failure to question and seek to resolve issues related to the affordability and sustainability of Equitable Life's bonus declarations. In particular, the Government considers that it does not take into account whether the regulatory failure identified resulted or was likely to have resulted in an injustice to those reading Equitable Life's regulatory returns. The Government has considered this issue and concluded that no injustice did arise since the issues raised by the Ombudsman do not demonstrate that Equitable's practice in relation to such bonus payments were other than in accordance with the regulatory valuation requirements set out in the applicable legislation. The extent to which Equitable's bonus approach was prudent in a purely commercial sense was primarily a matter for the Society.

**4.48** The Government considers that the basis for the Ombudsman's finding in relation to the affordability and sustainability of Equitable Life's bonus declarations is unclear. The Report appears to criticise Equitable Life's approach to declaring bonuses, but does not explain the basis for any criticism.

### *'Interest rate differential'*

**4.49** One specific criticism by the Ombudsman concerns Equitable Life's use of an 'interest rate differential' (Chapter 10, paragraphs 178 - 183). Equitable Life's use of an interest rate differential did not amount to a breach of the applicable regulations, as the Ombudsman accepted in her Report (Chapter 10, paragraphs 197).

**4.50** The Ombudsman explains that the application of an interest rate differential involved Equitable Life using valuation interest rates, less any explicit allowances for bonuses, which were higher than the guaranteed investment return. It is not clear whether the Ombudsman is suggesting that there should have been a direct, mechanistic relationship between the valuation interest rate and the guaranteed investment return. However, if that suggestion is being made, the Government considers that this is incorrect. There was no requirement – either in the regulations or in professional guidance – that the allowance for future reversionary bonus should be at a level equal to the risk-adjusted yield on the assets. Nor was this generally accepted as a requirement within the actuarial profession.

## *'Affordability and sustainability'*

**4.51** Since there was no basis for regulatory action in relation to Equitable Life's use of an interest rate differential, the Government has considered whether there is any other basis for criticising the affordability or sustainability of Equitable Life's bonus declarations in the context of the regulatory regime in place at the time. In the Government's view there is no such basis, for the reasons set out below.

**4.52** In its appendix valuation, Equitable Life valued its business using a net premium methodology. The effect of this, for the purposes of setting bonus levels, was that any difference between the Society's valuation interest rate and its risk adjusted yield (the safe and reliable yield on Equitable Life's investments) was available to pay both future bonuses and the guaranteed investment return (i.e. what Equitable Life had to pay to policyholders by way of guaranteed additions to benefits). In addition to the difference between the valuation interest rate and its risk adjusted yield, Equitable Life's business would have generated other profits (such as lower expenses on products than anticipated).

**4.53** Equitable Life would set its allowance for future bonuses each year having regard to the above, namely the difference between the valuation interest rate and its risk adjusted yield, plus the business' additional profits. From the 1996 regulatory returns onwards, data is available to show that the difference between the valuation interest rate and its risk adjusted yield, after allowance for the guaranteed investment return, was around 0.5% to 0.75% pa. This amount - an allowance for future bonuses - was therefore set aside by Equitable Life each year in its reserves. The Government is further advised that these bonus allowances paid sufficient regard to the reasonable expectations of policyholders in the context of the regulatory regime in place at the time.

**4.54** The available data therefore demonstrates that Equitable Life did have sufficient reserves in place, for the purposes of the regulatory requirements applicable at the time, to meet the cost of future bonuses from 1996. From that date future bonuses can be said to have been affordable and sustainable at levels which would have met policyholders' reasonable expectations. The Government is advised that, since the approach outlined above was standard actuarial practice, there is no reason to consider that Equitable Life's approach to future bonuses for the period 1990 to 1993 (and indeed the years 1994 and 1995 covered by the Ombudsman's fourth finding) - in respect of which corresponding data is not available - would not have been similar, with bonus declarations for this period also being affordable and sustainable.

**4.55** The Government therefore considers that there is no basis for the Ombudsman's finding that there was, or was likely to have been, injustice resulting from such maladministration (Chapter 12, paragraph 94). If GAD had raised the issues of affordability and sustainability of future bonuses with Equitable Life, the Society would have been able to establish that its approach to future bonuses was sustainable and affordable (in the sense that it was complying with the applicable valuation regulations) between 1990 and 1993 (this finding) and 1994 and 1996 (the fourth finding). The Government therefore does not accept this part of the finding of injustice.

## **FINDING 3: INTIMATION OF THE DIFFERENTIAL TERMINAL BONUS POLICY**

### **Summary of findings**

**4.56** The Ombudsman finds that when GAD identified the introduction by Equitable Life of its differential terminal bonus policy it failed a) to inform the regulator about the policy, b) to raise the matter with Equitable Life, or c) to seek to identify the rationale for the introduction of that policy and how it was being communicated to policyholders (Chapter 10, paragraph 297).

**4.57** The Ombudsman has determined that this failure constitutes maladministration (Chapter 11, paragraph 55). The lost opportunities to take informed decisions about their financial affairs during the period from July 1994 to April 1999 in full knowledge of Equitable Life's exposure to Guaranteed Annuity Rates ("GARs") and of the risks that such exposure generated are further found to constitute injustice to policyholders (Chapter 12, paragraph 121).

### **Government's response**

**4.58** The Government accepts that part the Ombudsman's findings of maladministration which relates to the failure by GAD to alert the regulator to Equitable Life's introduction of the differential terminal bonus policy. However, the Government does not accept the remaining findings of maladministration which relate to the failure by GAD to raise the matter with Equitable Life and its failure to seek to identify the rationale for the introduction of the policy and how it was being communicated to policyholders.

**4.59** The Government also does not accept the Ombudsman's finding of injustice because it does not agree with the Ombudsman's analysis as to what would have transpired had the regulator raised the differential terminal bonus policy with Equitable Life. Furthermore, it notes that the Ombudsman decided that she could find no financial loss resulting from the maladministration she found.

### **Maladministration**

**4.60** The Government accepts that GAD should have alerted the regulator to an apparent change in bonus policy evidenced by the introduction by Equitable Life of the differential terminal bonus policy.

**4.61** However, the Government does not accept the Ombudsman's findings that, firstly, the failure by GAD to raise the matter with Equitable Life and, secondly, the failure by GAD to seek to identify the rationale for the introduction of the policy and how it was being communicated to policyholders amounted to maladministration.

**4.62** In this respect, the Government notes that Equitable Life's differential terminal bonus policy was not unusual or out of the ordinary and was widely regarded by the actuarial profession as permissible at the relevant time. Thus GAD had no reason to single Equitable Life out for investigation simply by reason of its differential terminal bonus policy.

**4.63** The full implications of the policy for Equitable Life only emerged when the House of Lords gave its judgment in the *Hyman* litigation in 2000. The House of Lords, in giving its judgment



on the validity of the differential terminal bonus policy, brought an end to protracted litigation in which the arguments put forward on behalf of Equitable Life were far from unmeritorious, as indicated by the decision in Equitable Life's favour by the Vice-Chancellor and the split decision in the Court of Appeal. It is only with the benefit of hindsight, including knowledge of the House of Lords' decision in 2000, that the implications of the differential terminal bonus policy for Equitable Life became clear.

**4.64** Furthermore, the Ombudsman makes no express finding that the adoption of the differential terminal bonus policy by Equitable Life was an impermissible means of controlling its underlying exposure to future liabilities, or that Equitable Life was at that time in breach of any reserving requirements. The Government does not consider that there is adequate support for a finding that GAD's failure to raise the matter with Equitable Life or to ascertain the rationale for the introduction of the policy constitutes maladministration.

## Injustice

**4.65** The Government does not accept the Ombudsman's finding of injustice. This finding is based on a suggested sequence of events which, on the Ombudsman's analysis, would have transpired had the regulator raised the differential terminal bonus policy with Equitable Life. The Government is of the view that these proposed events are speculative in nature and do not support a finding of injustice.

**4.66** The Ombudsman's consideration of the consequences of the alleged maladministration include the assertion that, had the regulator engaged with Equitable Life about its adoption of the differential terminal bonus policy, then:

- it seems likely that Equitable Life would have obtained legal advice at that time, which might have had significant consequences (for example by bringing a large number of people who were otherwise not eligible for compensation for mis-selling within the scope of such compensation);
- it is possible that Equitable Life would have decided to test its differential terminal bonus policy in the courts sooner than it did, and to ensure that the illustrations and advertisements provided to existing and potential policyholders explained the policy and practice;
- Equitable Life would not have taken decisions (such as its decision not to ring-fence new entrants into a different fund) believing that it had tacit regulatory approval for its policy and associated practices;
- Equitable Life may have started reserving for its GAR liabilities sooner and taken decisions about its future direction in full knowledge of its reserving requirements; and
- Equitable Life (together with GAD/the regulator) would have had the opportunity to begin to address the issues which ultimately caused it to close to new business much earlier than it eventually did.

**4.67** The Government does not consider that there is any basis to conclude that any of the above consequences would, or were likely to, have followed had GAD or the regulator sought to query the adoption of the policy with Equitable Life.

**4.68** The Government does not consider that there is any basis to conclude that dialogue between GAD/the regulator and Equitable Life over the differential terminal bonus policy would have led to earlier reserving for GAR exposure.

**4.69** To the extent that the Ombudsman's conclusions in this respect are based on the suggestion that dialogue between the regulator and Equitable Life over the differential terminal bonus policy would have led to Equitable Life testing its policy in the courts sooner than it did, the Government respectfully disagrees. The trigger for Equitable Life commencing the *Hyman* litigation was the growing number of complaints from policyholders regarding the application of the differential terminal bonus policy. Those complaints were not received by Equitable Life in any significant number until 1997 and 1998, when the GARs became attractive and when terminal bonuses were being cut. The Government does not consider that there is any reason to suggest that Equitable Life was in breach of any prudential regulatory requirements by failing to inform policyholders of its decision to adopt the policy via its literature or that GAD/the regulator should have required it to do so. As such the information provided to policyholders was a matter for Equitable Life's board and management, not for the regulator.

**4.70** The Government does not consider that there is any basis to conclude that earlier discussions with Equitable Life about its differential terminal bonus policy would have led to any change in the policy; Equitable Life's response to any such inquiries would have been to provide the regulator with a copy of its legal advice, confirming the validity of the policy. Had discussions commenced before Equitable Life had sought legal advice then there is no reason to assume that it would not have obtained legal advice and that such advice would have been any different to that which was ultimately provided. Therefore any change in policy would have been a matter for the discretion of Equitable Life itself, not the regulator.

**4.71** In the absence of any suggestion that the use of a differential terminal bonus policy was considered at the time to be an impermissible means of managing exposure to future liabilities, the Government does not consider that there is any basis to conclude that questioning Equitable Life's adoption of the policy would have led to earlier reserving for GAR exposure. In this respect, the Government notes that the Ombudsman does not contend that Equitable Life was required, at the time it adopted the policy, to reserve for GARs. This was required only after GARs became valuable when market interest rates fell. This did not happen until 1995. In any event, the level of reserving which this would have required in 1995 and 1996 would have been easily achievable by Equitable Life and would have had little or no impact on the liabilities which crystallised as a result of the House of Lords' judgment.

**4.72** It follows that, even had GAD/the regulator acted differently, there is no reason to conclude that the other steps suggested by the Ombudsman would in fact have been taken. In the above circumstances, earlier inquiries by the regulator would not have been likely to trigger court action sooner. The Government considers that the scenarios which are outlined in the Report are speculative in nature. In the absence of any regulatory breaches by Equitable Life, the conduct of Equitable Life was matter for its board and management, rather than the regulator.

**4.73** The Government notes that the Ombudsman finds that it was not possible to conclude that any financial loss resulted from her finding of maladministration. She confined her finding of injustice to loss of opportunity, expressly excluding a finding of injustice in the form of financial loss.

## **FINDING 4: SCRUTINY OF EQUITABLE LIFE'S RETURNS FOR 1994 – 1996**

### **Summary of findings**

**4.74** The Ombudsman finds that GAD failed to question and seek to resolve issues within Equitable Life's regulatory returns for 1994 to 1996 related to a) the valuation rate of interest; b) the affordability and sustainability of Equitable Life's bonuses; c) apparently arbitrary changes to assumed retirement ages; and d) the holding of no explicit reserves for liabilities for tax on unrealised capital gains, for pensions mis-selling costs, and for GARs (Chapter 10, paragraph 343).

**4.75** The Ombudsman has determined that these failings constitute maladministration (Chapter 11, paragraph 60).

**4.76** Combined with Findings 2 and 5 the Ombudsman finds that injustice was sustained by any policyholder who relied on information in Equitable Life's returns from 1990 to 1996 and who suffered either a financial loss or a loss of opportunity to take an informed decision as a result of such reliance (Chapter 12, paragraph 100).

### **Government's response**

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

- maladministration concerning the valuation rate of interest;
- maladministration concerning the affordability and sustainability of Equitable Life's bonuses;
- 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.

**4.78** The Government does not accept those parts of the Ombudsman's finding which relate to:

- injustice concerning the valuation rate of interest;
- injustice concerning the affordability and sustainability of Equitable Life's bonuses;
- maladministration and injustice concerning the failure to hold no explicit reserves for prospective liabilities for tax on unrealised capital gains; and
- maladministration and injustice concerning the failure to hold explicit reserves for liabilities for pensions mis-selling costs.

### **Maladministration**

#### **Valuation interest rates**

**4.79** As in the case of finding 2, the Government accepts the finding of maladministration in respect of the failure to question and seek to resolve issues relating to Equitable Life's approach to valuation interest rates for the reasons explained in paragraph 4.32.

## Affordability and sustainability of bonuses

**4.80** The Government accepts the Ombudsman's finding of maladministration in respect of the affordability and sustainability of bonuses for the reasons explained in paragraph 4.33 above.

## 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.

## Reserving for liabilities for tax on unrealised capital gains

**4.85** The Ombudsman finds that Equitable Life failed to hold explicit reserves for prospective liabilities for tax on capital gains and that Equitable Life's coverage of these liabilities by margins elsewhere in the valuation basis was not consistent with the regulatory requirements (Chapter 10, paragraphs 313 to 315).

**4.86** The Government does not accept this part of the finding of maladministration on the basis that it considers that the Ombudsman has incorrectly interpreted the applicable regulatory requirements.

**4.87** There was no requirement in either the Insurance Companies Regulations 1994 ("the 1994 Regulations") or professional guidance note GN8 (issued by the Institute and Faculty of

Actuaries) for an explicit reserve for liabilities for tax on unrealised capital gains to be held for the non-linked business in question and no basis on which to question the implicit provision made by Equitable Life.

**4.88** The Ombudsman's findings are based on an incorrect view that it was not permitted to make implicit provision for tax on unrealised capital gains by means of reliance on margins elsewhere in the valuation basis. Neither regulation 60 nor regulation 64 of the 1994 Regulations nor the extract from GN8 referred to in the Report support this contention for the following reasons:

- nothing in the 1994 Regulations required an explicit reserve for tax on unrealised capital gains to be held, which would not have been established on a policy-by-policy basis;
- there was no requirement under the 1994 Regulations (or GN8) for a provision for tax on unrealised capital gains to be made in the form of a mathematical reserve (and hence to be subject to regulations 64 to 75). Instead, this could take the form of an accounting provision in Form 14, calculated in accordance with generally accepted accounting rules. This was explicitly provided for in the Insurance Companies (Accounts and Statements) Regulations 1983 (and the later 1996 Regulations which replaced them) ("the Accounts and Statements Regulations");
- where provision for tax on unrealised capital gains was made within the mathematical reserves, only regulation 64 was relevant, and this permitted the provision to be made implicitly or explicitly by means of reliance on margins elsewhere in the valuation basis. Again, this was stipulated in the Accounts and Statements Regulations. In circumstances in which the provision was made implicitly, on the basis that the Appointed Actuary considered that the margins in the valuation basis which he had used were already sufficiently large to meet each of the minimum requirements of regulations 65 to 75, and of regulation 64, he was required merely to indicate this directly or indirectly in Schedule 4 to the returns;
- regulation 60 had no bearing on a provision made for tax on unrealised capital gains. Regulation 60 was expressly subject to Part IX of the 1994 Regulations. Because the unrealised capital gains for which provision was being made arose under long term insurance contracts, the contingent liability which existed in respect of them was a long term liability and therefore fell to be determined in accordance with regulation 64;
- GN8 was entirely consistent with the position under the 1994 Regulations described above. Paragraph 3.3.1 of GN8 prohibited the offsetting of margins required by regulations 65 to 75, and required each valuation assumption to satisfy those regulations. However, it did not say anything about margins which went beyond the requirements of those regulations – the excessiveness referred to in paragraph 3.3.1 of GN8 was any which the Appointed Actuary considered to exist within the provisions or margins required by regulations 65 to 75. In particular, therefore, where margins existed in the valuation basis that went beyond those needed to meet the requirements of regulations 65 to 75, those excess margins could be relied upon by the Appointed Actuary for the purpose of making an implicit provision under regulation 64;
- in both 1994 and 1995, Equitable Life chose to make provision for tax on unrealised capital gains in respect of its linked business by means of an explicit mathematical reserve, but for its non-linked business it chose to make this provision

implicitly within the mathematical reserves, as provided for by regulation 64 and GN8, and provided the required disclosure described above.

**4.89** Given the above, the issue for GAD in considering whether or not to challenge Equitable Life's approach was whether or not it was evident that sufficient margins (in excess of those required to comply with the individual regulations 65 to 75) existed in the valuation basis to provide implicitly for the disclosed contingent liability for tax on unrealised capital gains. Given that this disclosed liability was only £22m in 1994, £37m in 1995 and £48m in 1996 – equivalent, for example, to an estimated margin of only some 0.04%, 0.05% and 0.06% in the valuation interest rate used in 1994, 1995 and 1996 respectively for the main block of recurrent single premium with-profit business – it was entirely reasonable for GAD to have reached the view that the existence of sufficient margins was self-evident and, in accordance with prudential guidance, consequently not to have raised this point with Equitable Life.

### Reserving for liabilities for pensions mis-selling

**4.90** The Ombudsman finds that Equitable Life failed to hold explicit reserves for pensions mis-selling costs and that Equitable Life's coverage of these liabilities by margins elsewhere in the valuation basis was not consistent with the regulatory requirements (Chapter 10, paragraphs 313 to 315).

**4.91** The Government does not accept this aspect of the Ombudsman's finding of maladministration on the basis that she has incorrectly interpreted the applicable regulatory requirements.

**4.92** The Government's position on reserving for pensions mis-selling costs is the same as for the liabilities for tax on unrealised capital gains, which is set out fully in paragraphs 4.85 to 4.89 above. In particular, there was no requirement under the 1994 Regulations (or GN8) to make explicit provision for potential compensation costs for pensions mis-selling.

## Injustice

**4.93** The Government suggests that the Ombudsman's view of the impact on Equitable Life's solvency position of the findings of maladministration may be overstated. Indeed the Ombudsman's finding of injustice is based on the premise only that Equitable Life's published financial position *could* have been considerably understated. The following sections consider the extent of the impact of the findings of maladministration.

### Valuation interest rates

#### *Valuation interest rates – 1994 returns*

**4.94** The Ombudsman finds that, in relation to Equitable Life's returns for 1994 to 1996, there was a "continuation of the...issues which arose from the returns for 1990 to 1993...concerning discounting through the use of imprudent and/or impermissible valuation interest rates" (Chapter 10, paragraph 298).

**4.95** In relation to the 1994 returns, Equitable Life provided additional information to the regulator to justify the interest rates used. Whilst on initial analysis the yields set out in that additional information do not appear consistent with those in the relevant part of Equitable Life's regulatory returns, these differences can be explained easily, for the reasons set out below.

**4.96** For example, for variable interest securities the difference in the yields can be explained as the difference between running yields and gross redemption yields as shown in the note to the relevant part of the 1994 returns. The reason for the note was because, for variable interest securities, the regulatory returns had to show the running yield in accordance with the Insurance Companies (Accounts and Statements) Regulations 1983. However, the Insurance Companies Regulations 1994 permitted the use of gross redemption yields for use in the valuation.

**4.97** Therefore, any differences between the yields contained in different parts of the regulatory returns (specifically, Form 57 and Forms 45 and 46) are justifiable and the assets can in fact be matched to the liabilities to justify the interest rates used. Accordingly the Government does not accept that injustice could or would have resulted from the maladministration identified, and this part of the finding of injustice is rejected.

#### *Valuation interest rates – 1995 and 1996 returns*

**4.98** In relation to the 1995 and 1996 returns, there was nothing in those returns (or in the Ombudsman’s Report) to suggest that the interest rates used in those years did not comply with the regulations and were therefore not justifiable.

**4.99** As such, the Government considers that there is no basis for considering that any attempt by GAD to resolve issues relating to the valuation interest rates for the 1995 to 1996 returns would have resulted in any changes to the content of Equitable Life’s regulatory returns in the relevant years. Accordingly, the Government does not accept that injustice could or would have resulted from the maladministration identified, and this part of the finding of injustice is therefore not accepted.

#### *Affordability and sustainability of bonuses*

**4.100** The Government does not accept the finding of injustice in respect of the affordability and sustainability of bonuses for the reasons explained in paragraphs 4.47 to 4.55 above.

#### *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.

## Reserving for liabilities for tax on unrealised capital gains

**4.108** On the basis that the Government does not accept the finding of maladministration associated with reserving for liabilities for tax on unrealised capital gains, the Government also does not accept the Ombudsman's finding of injustice.

**4.109** Notwithstanding the Government's rejection of this finding of injustice, the Government notes that the amounts involved as a reserve for tax on unrealised capital gains for Equitable Life's non-linked liabilities were in any event only £22m in 1994, £37m in 1995 and £48m in 1996. Had Equitable Life's reserves been increased by these amounts, this would have reduced the level of cover for the required minimum solvency margin reported in the returns only from 2.36 to 2.32 in 1994, from 2.90 to 2.83 in 1995 and from 2.53 to 2.45 in 1996. As such, the Government considers that any changes to the solvency position contained in Equitable Life's returns would not have given readers a materially different impression of Equitable Life's financial position.

## Reserving for liabilities for pensions mis-selling

**4.110** On the basis that the Government does not accept the finding of maladministration associated with reserving for pensions mis-selling, the Government also does not accept the Ombudsman's finding of injustice.

**4.111** Notwithstanding the Government's rejection of this finding of injustice, the Government notes that the amounts involved as a provision for pensions mis-selling costs were in any event only £50m in each of the years in question. Had Equitable Life's reserves been increased by this amount, this would have reduced the level of cover for the required minimum solvency margin reported in the returns only from 2.36 to 2.26 in 1994, from 2.90 to 2.81 in 1995 and from 2.53 to 2.45 in 1996. As such, the Government considers that any changes to the solvency position contained in Equitable Life's returns would not have given readers a materially different impression of Equitable Life's financial position.



## **FINDING 5 – PRESENTATION OF EQUITABLE LIFE’S TWO VALUATION RESULTS**

### **Summary of findings**

**4.112** The Ombudsman finds that GAD failed a) to ask for information in relation to the 1995 regulatory returns (namely the figure for the resilience reserve in Equitable Life’s appendix valuation) which was necessary to enable it, as part of the scrutiny process, to be sure that Equitable Life had produced a valuation that was at least as strong as the minimum required by the Regulations; and b) to pursue information before it that the omitted information had led to users of the returns (specifically the credit rating agency Standard & Poor’s) misconstruing Equitable Life’s financial strength (Chapter 10, paragraphs 344 to 396).

**4.113** The Ombudsman has determined that these failings constitute maladministration (Chapter 11, paragraph 84).

**4.114** Combined with Findings 2 and 4 the Ombudsman finds that injustice was sustained by any policyholder who relied on information in Equitable Life’s returns from 1990 to 1996 and who suffered either a financial loss or a loss of opportunity to take an informed decision as a result of such reliance (Chapter 12, paragraph 100).

### **Government’s response**

**4.115** The Government accepts the Ombudsman’s finding of maladministration in relation to the failure to request the resilience reserve figure for 1995. However the Government does not accept that it was under any obligation to interpret or act on ratings produced by independent third parties. Nor does the Government accept that its failure to request for itself the amount of resilience reserve for 1995 was the cause of any misunderstanding by independent third parties. Therefore, that part of the finding of maladministration is rejected.

**4.116** The Government does not accept the finding of injustice.

### **Maladministration**

**4.117** The Government accepts that the failure to request the figure for the resilience reserve in Equitable Life’s appendix valuation in its 1995 returns constituted maladministration. Whilst there was no requirement for Equitable Life to disclose this information in its returns, the Government accepts that, without the figure, GAD could not be certain that the alternative method Equitable Life had used for its main valuation was consistent with the regulations and would therefore have missed an opportunity to act had Equitable been in breach of those regulations.

**4.118** The Government would point out that paragraph 348 of Chapter 10 of the Report contains an inaccuracy, in that Equitable Life’s appendix valuation for 1996 included the amount of the resilience reserve that would be needed if the Society had used the statutory minimum basis (see, for example, paragraph 198 of Chapter 6 of the Report and page 271 of Part 3).

**4.119** The Government does not, however, accept that GAD or the regulator were under any duty to act in response to the credit rating produced by Standard & Poor’s.

**4.120** In this respect, it is relevant to note that (quite apart from whatever view Equitable Life itself took as to the appropriate information to supply to its policyholders) there was no *regulatory* requirement on the Society to include the amount of its resilience reserve in its returns. In these circumstances, and in any event, it is not accepted that rating agencies, or other industry commentators on whom reliance might reasonably have been placed by policyholders, were misled by Equitable Life's returns in this respect, nor that, even if they were, the regulator or GAD bore any responsibility for this.

**4.121** The nature of rating agencies' work was to undertake analysis and make their own, independent assessment of companies. In carrying out this task, the rating agencies had access not just to the returns but also to additional information (including information that was not in the public domain), and it was reasonable to expect them to discuss any issues arising with the companies they were rating.

**4.122** To the extent that rating agencies placed any reliance on Equitable Life's appendix valuation, and if they failed to recognise from the disclosure provided in the returns that the amount of the resilience reserve required in that valuation was not disclosed, then those were entirely matters for the agencies concerned. The regulator and GAD had no duty to vet the rating agencies' understanding of the regulations or to rectify any perceived inaccuracies or misunderstandings on the part of the agencies; it was for the agencies to analyse the results of the main and appendix valuations and the disclosure provided in relation to the resilience reserve required in the appendix valuation, and to seek any further information they required to be satisfied that they fully understood the position before commenting on it.

## **Injustice**

**4.123** The Government does not accept the Ombudsman's finding of injustice, which relies on the assumption that the failure to request the resilience reserve figure in the appendix valuation gave rise to the provision of misleading information in Equitable Life's returns.

**4.124** As indicated above, throughout the period in question there was no regulation requiring Equitable Life to disclose the way in which the resilience reserve had been calculated, or the amount of that reserve, in the net premium valuation. There is no consideration in the Report of the likely response from Equitable Life, had GAD or the regulator sought information as to the size of the resilience reserve. In its returns, Equitable Life made proper provision for resilience reserves, in accordance with the terms of the regulatory regime then in place, in its appendix valuation (that valuation complying with the Insurance Companies Regulations 1981 and 1994 generally) for the purpose of demonstrating that the alternative method it had used for its main valuation was consistent with the regulations - as the Ombudsman acknowledges, the amounts of those reserves were disclosed to GAD by Equitable Life in each year, with the exception of 1995.

**4.125** Equitable Life also made proper provision for resilience reserves, in accordance with the terms of the regulatory regime then in place, in its main valuation (that valuation complying with the Insurance Companies Regulations 1981 and 1994 generally), the results of which were reflected in Form 9 of the returns. Before 1994, no resilience reserve was required in the main valuation when the comparison against the minimum net premium valuation (including any resilience reserve required under regulation 55 of the Insurance Companies Regulations 1981, the amount of which did not however need to be disclosed in the returns) was satisfactory. From 1994, the requirement to comply with regulation 75 of the Insurance Companies Regulations 1994 applied to both the main and appendix valuations. However, no resilience reserve was actually required in Equitable Life's main valuation in either 1994 or 1995, for the

reasons disclosed in paragraph 5(1)(a) of Schedule 4 to its returns for those years. The Ombudsman does not suggest otherwise.

**4.126** With regard to the disclosure provided in the returns, to the extent that policyholders were interested in the basis on which the liabilities had been valued in the main valuation (on which Equitable Life's reported solvency position was based), full details of this were provided in Schedule 4 to the returns as for any other company.

**4.127** Schedule 4 also included certification by the Appointed Actuary of compliance with the regulations, and provided assurance that the main valuation was supported by a net premium valuation complying with the regulations.

**4.128** In respect of each of the years in question, it was possible to facilitate quantification of the difference between the aggregate reserves held in the main and appendix valuations without recourse to the information in the returns. Furthermore, the Government does not accept that policyholders or other readers of the returns would have sought to compare the two valuations in the way suggested by the Ombudsman, or that policyholders or other readers of the returns could have been misled as to Equitable Life's true financial position in this respect. Such a comparison was not necessary in order to understand the reported solvency position (as shown in Form 9 of the returns), which was based solely on the main valuation. As stated above, Equitable Life had established an appropriate resilience reserve, in accordance with the terms of the regulatory regime then in place, and its response to any inquiry by GAD or the regulator would have demonstrated this. As such, any request for the resilience reserve figure would have led to Equitable Life's regulatory returns being unchanged from those published, and no injustice can therefore have followed from the failure to request the figure for 1995 or to take other action.

## **FINDING 6: FINANCIAL REINSURANCE**

### **Summary of findings**

**4.129** The Ombudsman finds that the FSA, acting on behalf of the regulator, failed a) to ensure that the reinsurance arrangement (pursuant to the treaty entered into between Equitable Life and IRECO ("the Treaty")) was not taken into account in Equitable Life's 1998 returns without an appropriate concession being given; and b) to ensure that the credit taken for the arrangement in its 1998, 1999 and 2000 returns properly reflected the economic substance of the Treaty (Chapter 10, paragraphs 397 to 486).

**4.130** The Ombudsman has determined that these failings constitute maladministration (Chapter 11, paragraph 101).

**4.131** The Ombudsman finds that injustice was sustained as a result of the maladministration as follows: a) in respect of all those who joined Equitable Life or paid a further premium which was not contractually required after 1 May 1999, any financial loss sustained constitutes injustice in consequence of that maladministration, and b) those affected by the maladministration have also suffered injustice in the form of lost opportunities to take informed decisions about their financial affairs (Chapter 12, paragraph 146).

## Government's response

**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.

## **FINDING 7: DISCLOSURE OF POTENTIAL IMPACT OF HYMAN LITIGATION**

### **Summary of findings**

**4.141** The Ombudsman finds that the FSA, acting on behalf of the regulator, failed to pursue the issue of the proper disclosure within Equitable Life's regulatory returns for 1998 and 1999 of the potential impact of Equitable Life losing the *Hyman* litigation (Chapter 10, paragraph 522). The Ombudsman raises two particular matters the disclosure of which the regulator ought to have pursued: the cost of compensating GAR policyholders arising from an unsuccessful defence in the *Hyman* litigation of the differential terminal bonus policy; and the termination of Equitable Life's financial reinsurance arrangement.

**4.142** The Ombudsman has determined that this failure constitutes maladministration (Chapter 11, paragraph 123).

**4.143** However, she makes no finding as to whether injustice resulted because, in her view, anybody affected by this maladministration would already be covered by the finding of injustice in relation to the financial reinsurance arrangement (Chapter 12, paragraph 149).

### **Government's response**

**4.144** The Government accepts the Ombudsman's finding of maladministration for the reasons given below.

**4.145** Given that the Ombudsman makes no specific finding of injustice, the Government makes no comment under that heading.

### **Maladministration**

**4.146** The Government accepts the Ombudsman's finding of maladministration. However, the Government wishes to explain the basis on which this finding is accepted. It recognises that the FSA had made requests to Equitable Life that it reflect the potential impact of losing the *Hyman* litigation in its returns. Having made these requests, the FSA thereafter did not follow them up with Equitable Life.

**4.147** The Government does not accept that there was any regulatory requirement on the part of Equitable Life to disclose this information in its returns nor did the regulator have any power so to require. As such the issue of whether and how to disclose the information was a matter for the board and management of Equitable Life. The actions of the FSA should be seen in this context. In particular, and in light of the above, the Government does not accept that the

maladministration identified had any practical impact on the contents of Equitable Life's returns for the reasons outlined below.

### Disclosure of the cost of compensating GAR policyholders

**4.148** As recognised by Equitable Life's auditors and the regulator, and reinforced by legal advice from Queen's Counsel, the loss of the *Hyman* case was a remote possibility. Applicable guidance stated that "remote contingent liabilities" did not need to be disclosed in the returns.

**4.149** Even if this had been a "contingent liability", the regulatory requirement to disclose could be disregarded where the value of one or more contingent liabilities did not exceed 2½ per cent of the long term or general business amount. In this instance the estimated compensation costs were comfortably below that figure.

**4.150** Therefore the issue of whether or not to disclose the potential costs to Equitable Life of having to compensate GAR policyholders was a matter for the board and management of Equitable Life, not the regulator.

### Disclosure of Equitable Life's reinsurance arrangement

**4.151** It is not accepted that the disclosure requirement necessitated a detailed description of all the circumstances in which the terms of the reinsurance treaty might fall to be amended.

**4.152** In the light of legal advice, Equitable Life had reached the conclusion that it would be able to keep the differential terminal bonus policy in place. Given this, the Government does not accept that the summary indication of the nature and extent of the cover under the reinsurance treaty included in the 1998 and 1999 returns was unreasonable, or that it departed from practice at the time. There were a number of other events (apart from discontinuation of the differential terminal bonus policy) that could have given rise to amendment or termination of the Treaty. Such treaty conditions were, and are, common. They were not expected to be disclosed in the returns at the time and thus disclosure was at the discretion of Equitable Life.

**4.153** The termination of the Treaty could not be considered to give rise to a contingent liability because (1) the Appointed Actuary's view as to the value of the risk that the reinsurance treaty would not be available would have been allowed for in the overall value attributed to the reinsurance treaty when calculating long term liabilities; and (2) Equitable Life considered, on the basis of advice from Queen's Counsel, that the loss of the *Hyman* case was a remote possibility; it therefore did not fall to be disclosed in the returns, having regard to the existing guidance on remote contingent liabilities.

**4.154** In any event, as in relation to the cost of compensating GAR policyholders, the amount of any such contingent liability would not necessarily have exceeded the 2½ per cent of the long term business threshold described above.

**4.155** As the Ombudsman accepts, the regulator did suggest to Equitable Life that it should include a statement in its returns concerning the risk of successful challenge to the differential terminal bonus policy, as indicated in HM Treasury's letter to Equitable Life dated 7 December 1998. Despite this suggestion, for the reasons given above, the inclusion of such a statement was, in the Government's view, a matter ultimately for Equitable Life.

## Injustice

**4.156** Given that the Ombudsman makes no specific finding of injustice, the Government makes no comment under this heading other than to state that, given the comments above, the Government does not accept that any injustice would have resulted from the maladministration found by the Ombudsman.

## FINDING 8 – RECORDING THE DECISION TO ALLOW EQUITABLE LIFE TO REMAIN OPEN

### Summary of finding

**4.157** The Ombudsman finds that the FSA, acting on behalf of the regulator, failed to make a contemporaneous record of its decision to allow Equitable Life to remain open to new business after it had lost the *Hyman* case in the House of Lords (Chapter 10, paragraphs 523 to 613).

**4.158** The Ombudsman has determined that this failure constitutes maladministration (Chapter 11, paragraph 135). However, she finds that no injustice was caused to current or potential policyholders by the lack of any record of the decision (Chapter 12, paragraph 153).

### Government's response

**4.159** The Government accepts this finding of maladministration on the basis set out below.

### Maladministration

**4.160** The Government accepts the Ombudsman's finding of maladministration, since it is accepted that the FSA failed to record what was an important decision.

**4.161** Whilst not wishing to detract from the importance of record-keeping, the Government would point out that the failure identified took place in a situation where the FSA was undertaking a significant amount of work in a very short space of time in order to analyse the impact of the *Hyman* decision - not only in relation to Equitable Life but also in relation to the wider financial sector.

## Injustice

**4.162** The Ombudsman finds that, in this instance, the maladministration did not lead to injustice.

## FINDING 9 – THE BASIS FOR THE DECISION TO ALLOW EQUITABLE LIFE TO REMAIN OPEN

### Summary of finding

**4.163** The Ombudsman finds that the decision of the FSA, acting on behalf of the regulator, to allow Equitable Life to remain open following the loss of the *Hyman* litigation was not grounded in a sound factual or legal basis (Chapter 10, paragraphs 523 to 614). She finds that the FSA left

out of account a number of relevant considerations and did not take account of the powers available to the regulator to protect existing or potential policyholders.

**4.164** However, the Government notes that the Ombudsman does not allege that the regulator reached the wrong decision, but rather a) that whilst the key decision to allow Equitable Life to remain open was reasonable, the way in which it was reached was not appropriate, and b) that the decision was not properly recorded (see Finding 8)

**4.165** The Ombudsman has determined that this failure constitutes maladministration (Chapter 11, paragraph 142). However, she makes no finding as to whether injustice resulted, on the basis that anybody affected would already be covered by the finding of injustice in relation to the financial reinsurance arrangement (Chapter 12, paragraph 155).

## Government's response

**4.166** The Government accepts this finding of maladministration on the basis set out below.

**4.167** Given that the Ombudsman makes no specific finding of injustice, the Government makes no comment under that heading.

## Maladministration

**4.168** The Government accepts the Ombudsman's finding of maladministration on the basis that it accepts that the FSA did not give *full* consideration to each of the powers available to it before reaching its decision to allow Equitable Life to remain open.

**4.169** However, the Government does not accept any suggestion that the FSA did not take *any* account of the interests of both existing and potential policyholders and those paying new premiums.

**4.170** Furthermore, the Government would draw attention to the fact that the FSA took into account the following relevant considerations:

- the FSA was aware of the circumstances in which compensation for mis-selling would be available;
- it was reasonable for the FSA to have formed the view that the number of policyholders who might pay new premiums to Equitable Life (including existing policyholders) would be small relative to the total number of existing policyholders;
- the FSA was mindful of the risks of investing in Equitable Life during this period and this was a factor which was taken into account when balancing the interests of different groups of policyholders and potential policyholders;
- in light of the fact that monitoring of advertising was the responsibility of the conduct of business regulator, it was reasonable for the prudential regulator not to do so.

**4.171** In so far as relates to the decision ultimately taken by the FSA, it was the FSA's concluded view that in the light of the proposed sale of the business, there was no reasonable alternative to keeping Equitable Life open. In so far as the Ombudsman considers that there were realistic options available to the FSA that would have protected investors in Equitable Life and that were consistent with permitting Equitable Life the opportunity to find a buyer, the Government



disagrees. Any such options proposed would have undermined the sale process. In any event, as noted above, the Ombudsman does not find that the decision ultimately made by the FSA was the wrong decision.

**4.172** Furthermore, it would not have been appropriate for the FSA to have exercised any of the powers identified at paragraphs 571 to 576 of Chapter 10 of the Report (namely imposing a requirement on advertising, imposing a premium limitation, suspending Equitable Life's authorisation or persuading Equitable Life to delay banking of cheques and/or issuing policies) as to do so in the circumstances pertaining to Equitable Life at the time would have undermined the decision to allow Equitable Life to remain open and to seek to find a buyer.

**4.173** For the reasons outlined above, the Government considers that even had the FSA acted without maladministration, its decision would have been the same.

## **Injustice**

**4.174** Given that the Ombudsman makes no specific finding of injustice, the Government makes no comment under that heading other than to state that, in the light of the comments above, the Government does not accept that any injustice would have resulted from the maladministration found by the Ombudsman.

## **FINDING 10 – THE INFORMATION PROVIDED BY THE FSA IN THE POST-CLOSURE PERIOD**

### **Summary of findings**

**4.175** The Ombudsman finds that, during the period after Equitable Life closed to new business, the FSA, acting on behalf of the regulator, produced misleading information about Equitable Life's solvency position and its record of compliance with other regulatory requirements (Chapter 10, paragraphs 615 to 698).

**4.176** The Ombudsman has determined that this constitutes maladministration (Chapter 11, paragraph 160). The maladministration is said to have caused injustice to all those who can show a) reliance on the misleading information provided by the FSA; b) that such reliance was reasonable in all the circumstances; and c) that it led to a financial or other loss (Chapter 12, paragraph 168).

### **Government's response**

**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.

**4.186** Equitable Life itself provided material to policyholders which gave a more detailed picture of the fundamental uncertainties and financial difficulties it faced (Chapter 11, paragraph 154). This suggests that those policyholders who read information provided by the FSA were unlikely to have done so in isolation. Further, policyholders were explicitly reminded that the FSA could not give advice, and the FSA recommended that they seek suitable independent advice before taking any action.

**4.187** Given the context in which the FSA's information was made public, the Government would observe that the number of policyholders who could show reasonable reliance solely on statements made by the FSA is likely to be relatively few, if any. The Ombudsman's finding of injustice must be considered in that light.



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## The Government's response to the Ombudsman's recommendations

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**5.1** The Parliamentary Ombudsman has recommended that the Government should apologise for the sense of outrage caused by the maladministration she has found.

**5.2** The Ombudsman has concluded that maladministration has, in certain cases, caused injustice to Equitable Life policyholders and that this may have included a relative financial loss as defined in her report. The Ombudsman's second – and central – recommendation is that the Government should establish and fund a compensation scheme with the aim of restoring those who may have suffered a relative loss to the position that they would have been in had the maladministration not occurred.

**5.3** However, the Ombudsman recognises that the maladministration was only one among many contributory factors to the specific losses claimed by those who complained to her.

**5.4** The Ombudsman accepts that the creation of a compensation scheme would not be straightforward and that the best way to do this is for the Government and Parliament to decide. She also acknowledges that there may be an inherent conflict between speed and simplicity of delivery on the one hand, and fairness both to those affected and to taxpayers generally on the other.

**5.5** The Ombudsman has said that the scheme should be established within six months of any decision being taken to set it up and that its work should be completed within two years of its being established.

### Representations from interested parties

**5.6** The Government has received representations from Equitable Life that it should accept this recommendation.

**5.7** The Government has also received representations from policyholder action groups regarding various matters including the detail of the Ombudsman's recommendation and redress more generally. These representations generally supported the broad approach proposed by the Ombudsman. In particular, there was support for a compensation scheme which is transparent in operation and independent, and for a speedy conclusion. Other representations included the view that any compensation scheme should not be claims-based and that an assessment of losses should be undertaken on a collective rather than an individual basis.

**5.8** The Government has considered these representations in formulating its response.

## Public Administration Select Committee

**5.9** The Government has also taken account of the Public Administration Select Committee's Report on the Ombudsman's Report on Equitable Life which was published on 11 December 2008 (HC 41-I).

## Government's response

### Apology

**5.10** The Government has commented on the Ombudsman's individual findings in Chapter 4 of this document and accepts that there were some instances of maladministration and injustice. Such instances are unacceptable.

**5.11** On behalf of the public bodies investigated by the Ombudsman, the Government apologises to Equitable Life policyholders for those failures identified in the Ombudsman's report which are accepted in the Government's response. The Government acknowledges that many of those policyholders have suffered as a result of the events at Equitable Life.

### Compensation

**5.12** The Ombudsman recommended a compensation scheme to put those people who have suffered a relative loss back into the position that they would have been in had maladministration not occurred.

**5.13** The Ombudsman was far from concluding that everyone who had complained to her had suffered a financial loss. She also recognised the scale of her recommendation and the need for Parliament to take account of its impact on the public purse.

**5.14** The Government has given very serious consideration to this recommendation. The Government is concerned that maladministration has been identified by the Ombudsman, and in some cases injustice too. However, the question of compensation raises difficult and complex issues that need to be addressed.

**5.15** Firstly, the Ombudsman was only able within her remit to consider the role of the regulator and not the role and responsibility of Equitable Life and other parties. The Penrose Report, which had a wider remit, did set out a series of failings on the part of the Society.

**5.16** As the Public Administration Select Committee said in their report, "The current board of Equitable Life and many others have acknowledged the legitimacy of Lord Penrose's conclusion; few people dispute that its former management were primarily to blame." The Committee concluded, whilst supporting the Ombudsman's recommendation, that it would not be fair on taxpayers for public funds to pay for losses that are fairly attributable to the market or the former management of Equitable Life.

**5.17** Secondly, as the Ombudsman herself has said, the Government also has a responsibility to taxpayers generally to balance competing demands on the public purse. Her Report states, "I recognise that the public interest is a relevant consideration and that it is appropriate to consider the potential impact on the public purse of any payment of compensation in this case."

**5.18** The Public Administration Select Committee also said, “The decision to compensate must not, however, be the equivalent of signing a blank cheque on taxpayers’ behalf.”

**5.19** It is important to note that neither the Ombudsman nor the Government has been able to estimate the cost of the Ombudsman’s recommendation, as it does not have detailed information on the relative losses experienced by different groups of policyholders, nor on the factors affecting the losses of different groups.

**5.20** Thirdly, Parliament has accepted that it is not generally appropriate to pay compensation even where there is regulatory failure. The responsibility to minimise risks and to prevent problems occurring in a particular financial institution lies, first and foremost, with the people who own and run that institution. It would have serious repercussions for the nature and practice of regulation and the relationship between governments and financial markets were the taxpayer to provide a remedy for all losses whenever financial institutions fail and maladministration by the regulator was found.

**5.21** Therefore, for the above reasons, the Government does not accept that it would be appropriate to establish a compensation scheme in the way the Ombudsman has recommended. However, the Government does believe that government action is justified in this case.

## **The Government’s alternative proposal**

**5.22** The Government has reflected carefully on the Ombudsman’s report and also on the individual constituency cases raised by MPs. The Government recognises that there has been maladministration, and the representations it has received suggest that there has been a disproportionate impact on some Equitable Life policyholders. To that extent, the Government believes that some ex gratia payments will be warranted.

**5.23** The Government also considers that payments must also take account of the extent to which losses suffered by policyholders were the result of the maladministration which has been accepted, or can be attributed to other factors such as the conduct of Equitable itself.

**5.24** Neither the Ombudsman nor the Government currently has information on the precise extent of relative losses experienced by different policyholder groups, or on the extent to which losses were linked to maladministration. That can only be established through detailed analysis of the policyholder data held by Equitable Life.

**5.25** The Government has therefore invited Equitable Life to make full policyholder data available to it.

**5.26** The Government has also asked the Rt Hon Sir John Chadwick to advise on the following issues:

- Firstly, the extent of relative losses suffered by Equitable Life policyholders;
- Secondly, what proportion of those losses can be attributed to: (a) the maladministration accepted by the Government; and (b) the actions of Equitable Life and other parties;
- Thirdly, which classes of policyholder have suffered the greatest impact; and

- Fourthly, what factors arising from this work the Government might wish to take into account when reaching a final view on determining whether disproportionate impact has been suffered. The Government will consider Sir John's advice on the relevant factors before setting the criteria for the payment scheme.

**5.27** Sir John's terms of reference are set out in Annex A.

**5.28** Chapter 4 of this document explains the Government's basis for not accepting certain of the Ombudsman's findings. Those findings not accepted by the Government will not be taken into account by Sir John when formulating his advice.

**5.29** The Government has considered whether it is necessary to give Sir John statutory backing. Access to all information required to produce his advice would be assured if this approach were followed, but the start of the process would be delayed while the necessary primary legislation completes its Parliamentary passage. In the Government's view, this delay would be unacceptable.

**5.30** The Government urges all parties to co-operate with Sir John's work and make available all policyholder and other information which might be required.

**5.31** Many people have raised concerns about the length of time policyholders have had to wait for resolution of this case, and given that many have already retired, we do believe it is important to set up a scheme which can pay out as swiftly as possible taking account of the difficult practical considerations involved. We have therefore asked Sir John to advise as quickly as he is able, including providing interim updates and conclusions on a continuing basis so that work can progress on the practical issues in parallel without waiting unnecessarily for all his work to be concluded.

**5.32** To remove further potential for delay, Sir John has been asked to accept as definitive the Ombudsman's account of the events at Equitable Life, as set out in the narrative sections of Part 1 of her Report and in Part 3. In addition, it is not considered that it will be necessary for Sir John to seek further evidence (other than policyholder data) beyond that contained in publicly available documents, including the Penrose Report, the Ombudsman's Report and this response, together with written submissions from interested parties. However, Sir John will not be constrained from reviewing additional evidence should he reach the view that he must do so in order to fulfil his terms of reference.

**5.33** With the benefit of Sir John's advice, and taking account of the position of the public finances, and practical considerations, the Government will introduce a fair payment scheme for policyholders.





# Terms of Reference for the Rt Hon Sir John Chadwick

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Sir John Chadwick (“Sir John”) is appointed by HM Treasury to advise on matters arising from the Government’s response to the Parliamentary Ombudsman’s investigation into the prudential regulation of the Equitable Life Assurance Society.

The Government accepts five findings of maladministration in full, four findings in part, and rejects one finding. Within those findings four cases of maladministration resulting in injustice are accepted, as set out at Appendix 1.

In relation to those accepted cases of maladministration resulting in injustice, Sir John will advise HM Treasury on:

- The extent of relative losses suffered by different classes of policyholder 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;
- 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;
- The classes of policyholders which have suffered the greatest impact as a result of maladministration; and
- 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.

## Assumptions and evidence

Sir John will:

- 1 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;
- 2 Accept as definitive the Ombudsman’s account of the events at Equitable Life, as set out in the narrative sections of Part 1 of her Report and in Part 3;
- 3 Make such other findings of fact (if any) as he 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;

- 4 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;
- 5 If he deems it necessary, seek written representations as appropriate from interested parties.

Sir John will advise as quickly as he is able, including providing interim updates and conclusions on a continuing basis so that work can progress on the practical issues in parallel without waiting unnecessarily for all his work to be concluded.

## **Appendix 1: Summary of Government's Response to the Ombudsman's Findings**

The Government's response to the Ombudsman's findings is detailed in Chapter 4 of the Government's written response [Cm 7538]. Summarised below are those instances where the Government accepts that maladministration has led to injustice:

### **Finding 4 (scrutiny of Equitable Life's returns for 1994 – 1996)**

The Government accepts two instances of maladministration found by the Ombudsman within this finding that led to injustice to policyholders. These are summarised below.

#### ***Changes to retirement ages***

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.

In relation to injustice, it is accepted that the regulator ought to have satisfied itself that the changes to retirement ages were permissible. The Government accepts that Equitable Life might not have been able to justify their changes to retirement ages and that the regulatory returns might therefore have shown a different picture of the Society's solvency position.

#### ***Reserves for guaranteed annuity rates***

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). The Government accepts that GAD failed to confirm whether a GAR reserve was established in the 1995 returns.

In relation to injustice, the regulator should have required Equitable Life to establish explicit reserves for its GAR liability in the 1995 and 1996 returns. 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.

### **Finding 6 (financial reinsurance)**

The Government accepts that the reinsurance 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.

In relation to the injustice resulting from Equitable Life's use of reinsurance, the Government accepts that, because the regulator permitted credit to be taken for the reinsurance treaty, Equitable Life's returns gave a materially misleading picture as to its solvency.

## Finding 10 (information provided by the FSA in the post-closure period)

The Government accepts 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.

The Government accepts the finding of injustice, although it believes that the number of policyholders who could show reasonable reliance solely on statements made by the FSA is likely to be relatively few, if any.

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