

## **Please note**

The telephone numbers of the Parliamentary and Health Service Ombudsman changed on 15 March 2009.

The new contact details are:

**Helpline:** 0345 015 4033

**Fax:** 0300 061 4000

**Parliamentary Commissioner Act 1967**  
**Terms of Reference and Statement of Complaint**  
**for the Equitable Life Investigation**

**Investigation terms of reference**

The terms of reference for the investigation are:

*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.*

**Statement of complaint**

*Summary of complaint*

The complainants complain that the public bodies responsible for the prudential regulation of insurance companies (successively the Department of Trade and Industry, Her Majesty's Treasury and the Financial Services Authority, collectively referred to in the rest of this statement as 'the regulators') and the Government Actuary's Department (GAD) failed for considerably longer than a decade properly to exercise their regulatory functions in respect of the Equitable Life Assurance Society (ELAS) and were therefore guilty of maladministration.

*Specific complaints*

1. Organisational issues

- a. The regulators were not sufficiently resourced, and did not all possess the necessary skills, to contribute effectively to the overall regulatory process and to responsibly exercise their discretionary powers as intended by Parliament and by the European Community (now the European Union). Administrative decisions as to resourcing, priorities and methods contributed to a position in which the regulators did not properly undertake their functions as prudential regulator of ELAS.

- b. The regulators failed to liaise and to co-operate effectively with those responsible for the regulation of the conduct of business by insurance companies. In particular, they failed to ensure that proper assessments were made of ELAS's individual practices and its communications with policyholders, and of the expectations that these generated, in the light of the information that was, or should have been, known to the prudential regulators.

## 2. General operational issues

- c. The prudential regulators did not operate the regulatory regime as it was intended to be implemented by Parliament and in conformity with EC Directives. The regulators instead chose to regulate ELAS with a 'light touch' – a concept not evident from or provided for under the Insurance Companies Act 1982 and the EC Third Life Directive nor one consistent with these statutory provisions. The approach to the regulation of ELAS was exceptionally and unjustifiably lenient when compared to that adopted with other companies, with inadequate investigative site visits and lack of liaison with conduct of business regulators. Much more rigorous standards of supervision and better co-operation with conduct of business regulators were adopted for smaller and unit-linked companies. This demonstrated that the regulators applied a two-tier standard of regulation.
- d. The regulators and GAD allowed successive chief executives or managing directors of ELAS also to hold the post of appointed actuary, despite recognising the potential for conflict of interest in this position. These decisions were not consistent with the basis of the regulatory regime.
- e. The regulators and GAD failed to keep pace with developments in the pensions and life insurance industry and to assess and adapt their methods to reflect those developments. This was particularly critical in a situation in which narrow, technical interpretations of regulatory solvency were becoming an increasingly irrelevant measure of any insurer's realistic financial position as the industry moved more and more towards non-guaranteed bonus declarations.

- f. GAD had recommended ELAS as a pension plan or additional voluntary contribution scheme provider in its advice to the administrators of the Principal Civil Service Pension Scheme and to other public sector pension schemes. This led to a lack of proper separation of its responsibilities and to a clear conflict of interest between GAD's role in providing advice to government bodies in relation to public sector pensions and in assisting the prudential regulators of ELAS. This conflict of interest compromised the proper discharge of GAD's regulatory functions.

### 3. Supervision of regulatory solvency

- g. From the mid 1980s until 1997, the regulators failed to evaluate the potential effect of Guaranteed Annuity Rates (GARs) on the solvency of ELAS in a context where current annuity rates were falling steadily, in line with the Bank of England's base rate, to below contracted GARs. The regulators learned explicitly in November 1993 of the degree of ELAS's exposure to risks associated both with the GAR issue and with ELAS's lack of prudent reserves. The regulators' failure to take action then or to impose reserving until 1999 played a direct part in the closure of ELAS to new business and to subsequent cuts in policy and annuity values. The regulators did not prepare a study on the extent of GARs in the industry until 1997: a decade too late.
- h. From about 1990 onwards, the regulators and GAD failed to give sufficient consideration to the fact that some of the measures used to bolster ELAS's solvency position were predicated on the emergence of a future surplus. As a consequence, they did not properly assess the overall impact and adequacy of those measures. The regulators also allowed ELAS to mis-use the term 'surplus' and failed to consider the use of that word in the context of policyholders' reasonable expectations.
- i. Over this same period, the regulators allowed ELAS to publish financial results and projections that were misleading in that they did not reflect the Society's true position. In particular, ELAS was allowed to habitually report growth rates alongside

bonus rates, which gave the impression of a prudent margin for error, whereas the true position was that:

assets were consistently less than policy values so that higher rates of growth were needed to cover any given rate of bonus; and

as part of the growth was needed to cover expenses and the contractual liability for conventional annuities, the growth available to meet with-profits bonuses was always materially less than the rate quoted in ELAS literature. This was never made clear.

- j. During this period, the regulators and GAD failed to act when ELAS adopted what Lord Penrose described as practices of *'dubious actuarial merit'*. These included valuing future liabilities at an inappropriate rate of interest between 1990 and 1996; treating selling costs as an asset; making no provision for GARs until much too late; valuing a financial re-insurance policy (which proved to be of no value) at over £800 million; allowing credit for 'aspirational' (i.e. effectively unrealisable) assets; responding too slowly to widely evidenced changes to mortality expectations; and the issuing of a subordinated debt worth £346 million which did not count as a liability.
- k. On several specific occasions, as set out in the Penrose report, the regulators and GAD ignored or failed to act on information that might have led to formal or informal regulatory action against ELAS, thus also failing to alert new investors to the risks of investing. These include when ELAS board papers were sent to GAD by the appointed actuary on 11 June 1991, and when information was provided to GAD on 10 September 1992 which showed that, for the years 1989 to 1991, the aggregate policy values very significantly exceeded the value of the underlying assets.

#### 4. Payment of excess bonuses

- i. Over a period of many years the regulators and GAD permitted ELAS to operate an unsound business model, of which they were aware. ELAS had made public its policy of reliance on 'goodwill' in a 1989 actuarial paper *With Profits Without*

*Mystery*, but the regulators never addressed the issue or challenged ELAS about it or about the consequences of the model. Instead, they allowed ELAS to operate the model, which entailed declaring bonuses in excess of admissible assets, while at the same time operating without a significant estate and with a smoothing fund persistently in deficit. These were major contributory factors to ELAS's development of what Lord Penrose quantified as a £3 billion asset deficit at the time of closure to new business and to the losses incurred by all those who held policies on 16 July 2001.

- m. The regulators failed to ensure any satisfactory correlation between the total of declared policy values and ELAS's admissible assets in a context where ELAS, uniquely in the industry, had declared total policy values that included terminal bonuses and had, without exception, always paid all claims (both contractual and non-contractual) in accordance with these declarations.

#### 5. Policyholders' reasonable expectations (PRE)

- n. Ministers and officials decided that regulatory activities in relation to safeguarding PRE should be based solely on the regulatory returns, but failed to put in place adequate procedures and Regulations to enable this to be achieved. This failure was particularly critical in respect of ELAS, which had unique practices that elicited PRE.
- o. As a result, the regulators and GAD failed over many years properly to monitor and assess ELAS's asset position and its practices in the light of PRE. The regulators and GAD did not properly determine PRE or act to protect them as intended by Parliament and to the standards set by EC Directives.
- p. During the course of the *Hyman* litigation, the regulators failed in their duty to all policyholders in respect of PRE and postponed consideration of issues related to assets and reasonable expectations, both for GAR and non-GAR policyholders, until after the House of Lords judgment (20 July 2000). In addition, the regulators totally failed to assess properly either the impact or the scope of the judgment and to evaluate the range of scenarios for ELAS following it. They failed to take appropriate

action to mitigate the adverse affect of the judgment on the majority, non-GAR policyholders, and on new investors into the same with-profits fund. Their judgement that there was a 99.9% probability that ELAS would be sold demonstrated that, despite the extensive information that they possessed, the regulators failed to understand the parlous state of ELAS which was apparent to all prospective bidders.

- q. In March 2001, the regulators permitted ELAS to declare a bonus for 2000 and an interim bonus for 2001 that were both inappropriate and unjustifiable given the then state of ELAS's finances, thus raising misleading expectations about the true state of ELAS just prior to significant across-the-board cuts that were imposed only four months later. Instead, ELAS's asset deficit of 13% at year-end 2000 in a closed fund should have precipitated regulatory intervention at that time.
- r. In July 2001, the regulators failed to protect PRE by permitting policy value adjustments worth more than £4,000 million in the form of an inequitable uniform percentage cut across all with-profits policies, rather than the fairer alternative of reducing policy values by cutting only non-guaranteed bonuses. The regulators also refused to comment meaningfully on this to policyholders while discouraging independent financial advisers from giving proper advice to policyholders.

### **Remedy sought**

The complainants seek full financial redress for the losses they have incurred in consequence of the maladministration outlined above.