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

Responses to the statement of complaint:

Joint response from the Treasury, the FSA and GAD – Injustice

Government response on injustice

1. …

2. The statement of injustice contends:

> "As a direct consequence of regulatory failure each complainant lost 16% (or 14% for life policies) of their policy values on 16 July 2001 and in some cases they lost more in market value adjustments and other costs and penalties upon subsequent departure. Had the regulators effectively undertaken their responsibilities, the crisis at Equitable Life would have been prevented by earlier intervention and appropriate remedial action."

3. For all the reasons [we have] set out … we do not accept that there was regulatory failure, in the sense of a failure adequately to operate the regulatory regime in place at the material time.

4. Moreover, the assertion that the cuts and market value adjustments were a "direct consequence" of regulatory failure is ill-founded, for the reasons set out below.

5. Paragraph 87 of Chapter 6 of the Penrose Report does not set out a clear derivation of the relative proportions of the 16% cut in policy values attributable to the adverse investment conditions prevailing in 2000 and the first half of 2001 on the one hand and to the alleged past over-distribution (and in particular overpayment of past claims) on the other. However, the reader might reasonably infer from this paragraph, and from paragraph 75 of Chapter 6 and Table 6.14, taken together, that of the £4.9bn total cut in policy values, all but £1.5bn was attributable to events before the end of 1999. This impression is reinforced by the wording in paragraph 89 of Chapter 6 that:

> "apart from the losses attributable to market movements by June/July 2001, [the 16% cut in policy values] was the result of sustained over-allocation and sustained over-distribution on claims".

6. For the reasons set out in the following paragraphs, we do not accept that the 16% cut in policy values required in July 2001 was due to any material extent to any past over-distribution. Rather, the cut demonstrably reflected the adverse investment conditions prevailing in 2000 and the first half of 2001. Nor do we accept that any past over-distribution was a material factor contributing to the lack of a sale of ELAS, which as noted in the Response, arose for a variety of reasons, not all related to the financial strength of the with-profit fund.

ELAS's 2004 paper

7. Under the stewardship of its new Board, in October 2004 ELAS published a paper entitled "The Penrose Report: Policy value reductions and alleged 'over-bonusing'". The paper explains, rightly, that more than 14% of the 16% cut in policy values made in July 2001 was in fact attributable to:

   (1) adverse investment conditions prevailing between 1 January 2000 and that date;

   (2) adjustments made to the valuation of ELAS's liabilities (on a realistic basis) by the new Appointed Actuary; and

   (3) a decision (taken by the new Board on the advice of the new Appointed Actuary) to create as at 31 July 2001 an excess in the with-profit fund of available assets over aggregate with-profit policy values of £0.6bn as a prudential measure given the uncertain outlook for the future, broken down as follows:

1. approximately 11% due to the adverse investment conditions, reflecting the difference between the actual return on the fund during that period of minus 7.9%, net of expenses and allowing for the additional cost of the GARs (including the rectification scheme) incurred by the company following the House of Lords judgment in July 2000, and the rate of growth allocated to policy values during that period of 3.3%;

2. approximately 1% due to the adjustments made to the valuation (on a realistic basis) of liabilities[1], including reflecting a continued improvement in annuitant mortality, the effect of which was to increase those liabilities by some £0.2bn;

3. some 2.4% due to the decision to create the £0.6bn excess of available assets over policy values in the fund.

8. In fact, ELAS's figures are largely reflected in Chapter 6 of the Penrose Report itself:

(1) The £0.6bn excess of available assets over policy values is the £600m item referred to in paragraphs 75 and 87 of Chapter 6 and reflected in Tables 6.15[2] and 6.17[3] and financial table H4[4]. This represented a percentage excess of available assets over policy values (following the 16% cut) of some 3%, as reflected in financial table H4, which figure is within the tolerance range

[1] See Table 6.17 of the Penrose Report at page 226.
[2] See page 224 of the Penrose Report.
[3] Ibid. page 226.
[4] Page 32 of the Financial Tables to the Penrose Report.

of plus and minus 5% quoted by [redacted] on page 4 of Appendix F to the EMAG submissions.

(2) The net investment return of (7.9%) is close to the 2.7% gross return in 2000 shown in financial table D4[5] and quoted in paragraph 69 of Chapter 6, less the estimated 4.0% negative return in the first 6 months of 2001 quoted in that paragraph, less expenses of 0.8% (calculated as an annual rate of 0.5% multiplied by 1.5 to allow for the 18 month period to 30 June 2001) less the additional cost of the GARs following the House of Lords judgment of 4.7% (calculated as 7/12 * 8%, representing the value of the allocated growth rate of 8% for 2000 suspended during the first 7 months of that year, which was almost exactly equal to the additional GAR cost: see above). The difference of 1.1% can be explained by further investment losses (and expenses) incurred by ELAS during July 2001: the FTSE fell by a further 2% in that month and close to half of the assets of the fund were invested in equities at that time. (Differences between actual claims payments made during this period and the corresponding (unsmoothed) asset shares are also relevant to the precise reconciliation, but paragraph 69 of Chapter 6 of the Penrose Report indicates that these were not very significant.)

(3) The 3.3% allocated growth rate is the annual allocated growth rate of 8% for 2000 multiplied by 5/12 because the bonus was suspended for the first 7 months of that year.

9. No growth was allocated to policy values during the first 6 months of 2001[6]. An annual rate of growth of 6% was allocated to policy

[5] Ibid. page 16.
[6] See paragraph 149 of Chapter 5 of the Penrose Report.

values from 1 July 2001[7] so that 0.5% would have been allocated during July 2001. This growth has apparently not been allowed for in ELAS's calculations, but if this is the case then an even greater proportion of the 16% cut in policy values is in fact explained than presented in the October 2004 ELAS paper.

10. The only material difference between ELAS's figures in its October 2004 paper and Chapter 6 of the Penrose Report relates to the increase in liabilities, for which paragraph 80 of Chapter 6 suggests a figure of £400m rather than some £200m. However, the latter figure relates just to the annuitant mortality adjustment and it may well be that other adjustments were also made that decreased the liabilities. In particular, it is possible that the difference of £200m reflects the consequential reduction in the GAR provision resulting from the cut in policy values of £243m reflected in the difference between the two figures for this provision shown towards the bottom of Table 6.14[8]. But this minor point does not in any way affect the thrust of our submission. On the contrary, if the correct figure is in fact £400m, then an even greater proportion of the 16% cut in policy values can be sourced than is set out in the October 2004 ELAS paper.

11. So, it can be seen that only the modest balance of 1.6% of the total 16% cut in policy values is capable of being attributed to events which took place before the end of 1999. This is consistent with the fact that, even based on the figures in Chapter 6 of the Penrose Report without any adjustment, there was only a modest excess of policy values over available assets in the with-profit

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[7] Ibid.
[8] Page 223 of the Penrose Report.

fund of some 3% (in fact 2.8% based on Table 6.3) at the end of 1999[9].

Critique of Lord Penrose's analysis of the July 2001 policy value cut

12. In our view the analysis presented in paragraph 65 *et seq*. of Chapter 6 of the Penrose Report relating to the 16% cut in policy values is far from clear, especially as regards the assets side of ELAS's realistic balance sheet. It seems that Lord Penrose was unable to obtain all the information he would have liked relating to this period. In addition, Lord Penrose's analysis seems to reflect misinterpretation of certain of the figures appearing in papers to which he had access produced by the new Appointed Actuary of ELAS. In particular:

(1) The reference in paragraph 80 of chapter 6 to a £1bn reduction in assets in respect of estimated overpayments is very difficult to comprehend. The description of the £1bn assets adjustment provided in paragraph 83 of Chapter 6 is unclear. It seems likely that the point was not fully grasped by the Penrose inquiry. It is illogical in principle to make a deduction from the assets in respect of any past overpayment of claims because the assets will already have been reduced as a result of this. What is more, the adjustments presented in paragraph 80 only produce the revised "surplus of…under £400m" to which Lord Penrose refers in the last sentence if the £1bn reduction in assets claimed to have been made in respect of past overpayment of claims is in fact <u>not</u> made: opening

[9] The reason the 1.6% is 1.2% smaller than the 2.8% seems likely to be mainly attributable to the adjustments on the assets side of the realistic balance sheet of (£400m) relating to the write off of the new business loan and £590m relating to miscellaneous profits arising from disposal of parts of ELAS's business referred to in paragraph 80 of Chapter 6 of the Penrose Report, which together produced an increase in available assets of £190m or some 0.7% of policy values before the 16% cut. The 0.5% balance of the 1.2% difference is within the margins of rounding adjustments, it not being clear that the various percentages quoted in the different documents are in fact all applied to the exactly same quantum of policy values at the same dates.

surplus £600m - £400m new business loan write off + £590m miscellaneous profits from sales - £400m increase in liabilities = revised surplus £390m.

(2) For the same reasons, the accuracy of the adjustments shown in the top half of Table 6.17[10] is also very doubtful.

(3) Moreover, the revised surplus of some £400m quoted in paragraph 80 does not appear to be reflected anywhere else. Tables 6.15[11] and 6.17[12] and financial table H4[13] all show a surplus of £600m; and whilst the liabilities shown in Table 6.17 are £400m greater than those shown in Table 6.15, as expected from the increase in liabilities quoted in paragraph 80 of Chapter 6, it is wholly unclear why the assets shown in that table are also £400m higher (£22,900m compared with £22,500m). So too, the provenance of the net assets figure shown in Table 6.17 before the adjustments described above (a figure of £23,710m) is unclear. So far as we are aware, it does not appear anywhere else in the Penrose Report and no justification for it is made.

(4) The description of the aggregate figure of £4.3bn shown in paragraph 75 of Chapter 6 as the "value written off" is confusing because the total reduction in policy values was in fact the higher sum of £4.9bn quoted in that paragraph. The £4.3bn figure represents the amount by which policy values would have had to be reduced to produce an exactly balanced fund rather than the 3% excess of available assets over policy values that was in fact decided upon.

[10] Page 226 of the Penrose Report.
[11] Ibid page 224.
[12] Op cit.
[13] Page 32 of the Financial Tables to the Penrose Report.

Responses to the statement of complaint:

Joint response from the Treasury, the FSA and GAD – Injustice

(5) It is not immediately clear why the revised policy values after the 16% cut shown in Table 6.16[14] are not 16% lower than those shown in Table 6.13[15] (in fact they are all some 18.8% lower), although it is possible that there is a valid explanation for this.

(6) It is far from clear that the adjustments made towards the bottom of Table 6.14[16] make sense:

1. It is correct that the GAR provision should logically be 16% lower after the cut in policy values and hence an adjustment of £243m (= 16% of the pre-cut provision of £1.5bn) is appropriate. However, it is not clear that this has not already been allowed for implicitly in the Table given that the 16% cut is applied to the total policy values including the £1.5bn original GAR provision. The adjustment in respect of the suspended bonus is similarly counter-intuitive.

2. It is unclear why, if the aggregate policy values at the bottom of Table 6.14 are as at 31 July 2001, as claimed, no allowance appears to have been made for growth allocated during July 2001. As explained above, an annual allocated growth rate of 6% was applied from 1 July 2001 following the first 6 months of 2001 in which no growth was allocated.

[14] Page 225 of the Penrose Report.
[15] Page 222 of the Penrose Report.
[16] Page 223 of the Penrose Report.

Further points on the July 2001 policy value cut

13. We make three further key points on the July 2001 policy value cut in the context of the statement of alleged injustice… :

(1) First, it is very important to note that, even to the very modest extent (see above) to which the 16% cut in policy values did relate to events before the end of 1999, those policyholders as at 31 July 2001 who had also been policyholders throughout the period covered by Table 6.3 were no worse off overall. This is because they would also have benefited from any net over-distribution that took place in that period. The fact that such a policyholder was in a "near balanced position in cash terms" after the cut in policy values in July 2001 is acknowledged by Penrose in paragraph 57 of Chapter 6 of his Report. This is plainly a very important factor so far as the causation of any loss is concerned. The same is not necessarily the case for policyholders entering the fund in later years but, given that the aggregate deficit in available assets at the end of 1999 was only 3%, the bulk of the 16% cut in policy values for these policyholders also reflected events after and not before the end of 1999, as the above analysis demonstrates.

(2) Second, it is essential to appreciate that other companies were also making significant cuts in the values of their with-profit contracts during 2000 and 2001 as a result of the adverse investment conditions prevailing in those years. This is illustrated by the figures shown in the Appendix, which are taken from with-profit surveys published in *Money Management*. These show the actual maturity payments made by other major with-profit companies for sample 10 and 25 year regular premium life endowment contracts on 1 February

in each of the years 2000, 2001 and 2002. These contracts are of course not directly comparable to the recurrent single premium pension contracts comprising the bulk ELAS's with-profit business, and neither are amounts paid on maturity directly comparable to the aggregate policy values intimated to ELAS' policyholders in their individual bonus notices. However, the percentage changes in these maturity payouts during this period nevertheless do provide a broad indicator of the impact of the adverse investment conditions prevailing at that time, which, as explained above, made the primary contribution to the July 2001 cut in policy values. The figures show that maturity payouts fell on average by 12% and 18% for 10 and 25 year contracts respectively between 1 February 2000 and 1 February 2002 (a proxy for the period between the end of 1999 and the end of 2001), the bulk of these reductions being attributable to the year 2001, and that the largest reductions for these contracts over that period among the companies shown were as high as 18% and 23% respectively. These figures are in line with the 16% cut in policy values made by ELAS in July 2001. Again, the point is self-evidently of great importance to any analysis of the causation of any loss suffered by [complainants]. What is clear is that policyholders with funds elsewhere than in ELAS were exposed to broadly similar policy value cuts in 2001. The figures also demonstrate the extent of variation between companies: for example, for 25 year contracts maturing on 1 February 2002, the highest maturity value shown is as much as 63% greater than the lowest.

(3) Third, it should be noted that some 2.4% of the total cut was attributable to the creation of the £600m excess of available assets over policy values decided upon by the new ELAS Board. On the basis of the tolerance range of plus and minus 5% for

Responses to the statement of complaint:

Joint response from the Treasury, the FSA and GAD – Injustice

the relative level of these items quoted by [redacted] on page 4 of Appendix F to the EMAG submission, it would have been possible in principle for the cut to have been reduced to a level such that a deficit of available assets of 5% existed in the fund. This would have reduced the cut in policy values by approximately 7% to just 9%. The fact that ELAS chose instead to make the larger cut of 16% is not surprising. This provided a prudential margin given the uncertain outlook for the future, and to cover the additional cost to ELAS in respect of those policyholders who could take a contractual exit with a guaranteed fund higher than the policy value (as reduced by the cut). It was also sensible, given that making any cut would be unpopular, to make the cut large enough to avoid the need to make a further material cut in the foreseeable future having regard *inter alia* to the revised investment strategy, heavily biased towards the holding of fixed interest securities, being adopted by ELAS around that time and the need for future bonus declarations to be adjusted in a way that was compatible with the likely implications (including lower investment returns) of that changed strategy.

14. For all these reasons, … we believe that:

(1) the prudential regulator and GAD undertook effectively their responsibilities;

(2) it is wrong to say that the July 2001 policy value cut was in any material respect a consequence of "sustained over-allocation and sustained over-distribution on claims" as alleged by Lord Penrose;

(3) on the contrary, more than 14% of the 16% cut in policy values made in July 2001 was in fact attributable to:

Responses to the statement of complaint:

Joint response from the Treasury, the FSA and GAD – Injustice

1. adverse investment conditions prevailing between 1 January 2000 and that date;

2. adjustments made to the valuation of ELAS's liabilities (on a realistic basis) by the new Appointed Actuary; and

3. a decision (taken by the new Board on the advice of the new Appointed Actuary) to create as at 31 July 2001 an excess in the with-profit fund of available assets over aggregate with-profit policy values of £0.6bn as a prudential measure given the uncertain outlook for the future;

(4) it is not correct to say that even to the very modest extent to which the 16% cut in policy values did relate to events before the end of 1999, those policyholders as at 31 July 2001 who had also been policyholders throughout the period covered by Table 6.3 were any worse off overall;

(5) ELAS's policy value cut was not out of line with those imposed by other life insurance companies at about the same time. [Complainants] cannot demonstrate with any degree of certainty that sums invested elsewhere than ELAS would have fared better; and

(6) that there is no basis to the statement of alleged injustice.

Responses to the statement of complaint:

Joint response from the Treasury, the FSA and GAD – Injustice

APPENDIX

Maturity values for 10 year regular premium life endowment contracts

Company	1/2/2000	1/2/2001	% change from 1/2/00	1/2/2002	% change from 1/2/00
Clerical Medical	10,233	9,492	(7%)	8,416	(18%)
Friends Provident	9,742	9,420	(3%)	8,755	(10%)
Legal & General	9,406	9,666	3%	8,634	(8%)
Norwich Union	9,479	9,197	(3%)	8,305	(12%)
Prudential	9,675	9,574	(1%)	n/a	-
Royal & Sun Alliance	9,023	9,070	1%	7,802	(14%)
Royal London	10,372	10,590	2%	9,488	(9%)
Scottish Amicable	10,074	10,041	(0%)	8,604	(15%)
Scottish Equitable	n/a	8,745	-	8,949	-
Scottish Provident	9,228	8,851	(4%)	n/a	-
Scottish Widows	9,804	9,309	(5%)	8,094	(17%)
Standard Life	10,544	10,596	0%	9,875	(6%)
Average % change			(2%)		(12%)

Source: *Money Management*, April 2002. Figures represent actual maturity payouts at the dates shown for a male life age 30 next birthday paying a premium of £50 pm from 1992 onwards and £30 pm in earlier years.

Maturity values for 25 year regular premium life endowment contracts

Company	1/2/2000	1/2/2001	% change from 1/2/00	1/2/2002	% change from 1/2/00
Clerical Medical	104,289	100,117	(4%)	83,175	(20%)
Friends Provident	102,341	93,145	(9%)	82,100	(20%)
Legal & General	93,678	90,324	(4%)	75,141	(20%)
Norwich Union	89,518	86,028	(4%)	73,640	(18%)
Prudential	99,994	92,809	(7%)	n/a	-
Royal & Sun	104,201	96,712	(7%)	82,690	(21%)

Responses to the statement of complaint:

Joint response from the Treasury, the FSA and GAD – Injustice

Alliance					
Royal London	120,369	127,006	6%	107,745	(10%)
Scottish Amicable	96,569	91,854	(5%)	74,093	(23%)
Scottish Equitable	n/a	81,822	-	65,917	-
Scottish Provident	85,120	79,893	(6%)	n/a	-
Scottish Widows	95,482	91,538	(4%)	75,004	(21%)
Standard Life	110,373	110,136	0%	99,747	(10%)
Average % change			(4%)		(18%)

Source: *Money Management*, April 2002. Figures represent actual maturity payouts at the dates shown for a male life age 30 next birthday paying a premium of £50 pm from 1992 onwards, £30 pm in the years 1985 to 1991 and £10 pm in earlier years.