

FURTHER MEMORANDUM TO THE PUBLIC ADMINISTRATION SELECT COMMITTEE

BY THE EQUITABLE MEMBERS ACTION GROUP LIMITED -"EMAG"

INTRODUCTION

- 1 Equitable Members Action Group (EMAG) is the only substantial Equitable Life policyholder group, with a proper constitution, a money subscription and an elected Board of Directors. It has over 20,000 members.

We welcome the opportunity to give further evidence to the Public Administration Select Committee on the prudential regulation of Equitable Life, the report of the Parliamentary Ombudsman ("the PO") and the Government's response to that report.

- 2 This submission examines the effect in money and public administration terms of the Government's written response (Command 7538). The detailed computations have been prepared by Colin Slater FCA, partner in Burgess Hodgson, Chartered Accountants and a member of the Board of EMAG.
- 3 Colin Slater FCA with John Newman MA FCA (Chairman) and Paul Braithwaite (General Secretary) will be giving oral evidence to the Select Committee.

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EXECUTIVE SUMMARY

- 4 This memorandum comments briefly upon the Government's response to the Parliamentary Ombudsman's Report, concentrating upon the issues, which affect the quantum of loss and compensation and upon its public administration consequences.
- 5 Our previous submission estimated aggregate policyholder losses at about £4.8 billion and appropriate compensation, after adding exit penalties and interest and allowing various deductions, at £4.6 billion.
- 6 The really big loss/compensation money depends heavily upon the 1991-1996 findings that Equitable Life's regulatory returns, mal-administratively approved by the regulators, were grossly misleading.
- 7 As regards the 'money findings' the Government accepts virtually all the PO's findings of maladministration, but rejects virtually all her determinations that such maladministration led to injustice and where there is no injustice there is no compensation.
- 8 The Treasury proposes to appoint Sir John Chadwick to advise further, but has restricted his instructions so as to consider only those findings which the Government has accepted, eliminating at least 90% of policyholders' losses from his review.
- 9 However fair-minded Sir John Chadwick may be, the Treasury's instructions mean that the resulting compensation will be a very small fraction of the losses incurred by policyholders.
- 10 The 'Chadwick Process' falls a very long way short of the transparent and independent Tribunal recommended by the PO. Sir John Chadwick is a retired Appeal Court Judge, but in this instance he is merely acting as an advisor to the Treasury, itself found guilty, through its sub-contractor the FSA, of 5 counts of maladministration. Sir John owes no duty to Parliament and reports privately to the Treasury. He is not required to hear representations from interested parties. Parliament has no control over the timing of his work. The Government's action is arguably an insult to the Parliamentary Ombudsman and to Parliament.

THE PO'S FINDINGS

- 11 The Parliamentary Ombudsman ('PO') made 10 findings of maladministration, but, in order to lead to compensation, maladministration needs to result in 'injustice'. Furthermore, in order for loss / compensation to be substantial, the loss needs to be both significant and applicable to the generality of policyholders. Eliminating the findings which do not meet these criteria leaves what we regard as the PO's 'money' findings:

Table 1		
No	Finding	Injustice
	The unreliability of the Returns	
2 & 4	GAD's failure to question and seek to resolve questions for each year from 1990 to 1993 (Finding 2) and from 1994 to 1996 (Finding 4), related to (i) the valuation rate of interest used to discount the Society's liabilities and (ii) to the affordability and sustainability of the Society's bonus declarations	Injustice found, in respect of lost opportunities to invest elsewhere as a result of the misleading returns from 1 July 1991 onwards
3	GAD's failure, when the introduction of the Society's differential terminal bonus policy was identified as part of the scrutiny of the 1993 returns, (i) to inform the prudential regulators about the policy, (ii) to raise the matter with the Society, or (iii) to seek to identify what the rationale was for the introduction of the policy and how it was being communicated to policyholders	
&4	GAD's failure to question and seek to resolve questions ... related to (iv) the holding of no explicit reserves for ... guaranteed annuity rates	
5	GAD's failure ... (ii) to pursue the information before them that the omitted information had led to the users of the returns misconstruing the financial strength of the Society [i.e. that Standard & Poor's 'AA' rating of Equitable was based upon a misunderstanding of the two valuation methods used.]	
	Financial Re-Insurance	
6	The FSA's failure (i) to ensure that the financial reinsurance arrangement was not taken into account within the Society's 1998 returns without an appropriate concession being given, and (ii) to ensure that the credit taken by the Society within its returns for 1998, 1999, and 2000 properly reflected the economic substance of that arrangement	Injustice found, in respect of financial loss and lost opportunities to invest elsewhere for all those who joined the Society or paid a further premium that was not contractually required in the period after 1 May 1999

LOSS EVALUATION BASED UPON THE PO'S REPORT

- 12 Before considering the Government's response, it is important to note the general principle that the earlier findings relating to the unreliability of the Returns are much more valuable in terms of primary loss and compensation than the later ones. The table below shows the loss calculations made based upon the PO's 'money' findings above:

Table 2

Investment	Remaining Premium £m A	Total Value £m	Losses to Jan-01 per £10k premium B	Loss from Jul 1991 £m C	Division of Loss £m D
pre 1990	N/A	4,641			
1991	470	1,154	8,692	204	4,446
1992	656	1,456	7,517	493	
1993	868	1,733	6,254	543	
1994	1,016	1,825	5,647	574	
1995	1,406	2,302	4,782	672	
1996	1,913	2,855	4,080	780	
1997	2,437	3,274	2,548	621	
1998	2,649	3,200	1,746	463	
Jan-Apr 99	860	940	373	96	
May-Dec 99	1,721	1,879	747	193	355
2000	2,108	2,142	768	162	
	<u>16,105</u>	<u>27,401</u>		<u>4,801</u>	<u>4,801</u>

- 13 It will be observed from column B that those who invested with Equitable Life instead of 'elsewhere' in the earlier years lost much more than those who invested later. This is because 'Elsewhere Life':
- Did not have Equitable Life's GAR problem
 - Was not trying to recover from incoming members excessive bonuses paid to outgoing ones
 - Performed better as a result of higher equity exposure.
- 14 It will also be seen that the biggest periods for loss (columns C and D) in money terms are those from 1 July 1991 to 30 April 1999. If findings in respect of those periods, relating to the unreliability of the Returns, were overturned, then the remaining loss, relating to the financial reinsurance finding (from 1 May 1999) would be relatively small, about £355m out of £4,801m or about 7½%.
- 15 In fairness it must be said that late contributors suffered more losses than others in terms of leaving penalties, but the really big loss/compensation money (more than 90%) depends heavily upon the 1991-1996 findings.

THE GOVERNMENT'S RESPONSE

- 16 The table below concentrates upon the 'money' findings, for which the PO found maladministration leading to injustice and which we have re-grouped under more convenient headings, showing the Government's response.

Table 3

No	Subject	Government Maladministration?	Government Injustice?
2 & 4	Scrutiny of Equitable Life's returns for 1990 – 1993 (Finding 2) and for 1994 – 1996 (Finding 4)		
	Valuation interest rates	Accept	Reject
	Affordability and sustainability of bonus declarations	Accept	Reject
3	Differential terminal bonus policy (1993 Return)	Accept in Part	Reject
4	Reserves for guaranteed annuity rates	Accept	Accept For 1995 & 1996 only
5	Presentation of Equitable Life's two valuation results (misleading Standard & Poor's to rate Equitable 'AA') (1995 Return)	Accept in Part	Reject
6	Financial Reinsurance (1998 - 2000 Returns)	Accept	Accept subject to reservations

- 17 It will be observed that the Government accepts virtually all the PO's findings of maladministration, but rejects virtually all her determinations that such maladministration led to injustice. The above boils down to four issues:
- a) **Valuation interest rates.** Whether the rates used in the valuation of the Society's mainstream pension business in the returns from 1990 to 1996 inclusive were in accordance with the rules prevailing and whether those rates, if acceptable in themselves, cast material doubt over the sustainability of bonus declarations.
 - b) **GAR Problem.** Whether the regulators should have identified the GAR problem in its examination of the 1993 Return and insisted upon the liability being provided against in that and subsequent returns.
 - c) **Two Valuations.** Whether GAD's failure to take any action as regards its discovery that Standard & Poor's had been misled by the Society's two valuation methods resulted in loss/injustice to policyholders.
 - d) **Financial re-insurance.** Whether the Government's acceptance of the PO's financial re-insurance findings is too limited to be significant.
- 18 The above issues, the PO's findings and the Government's responses are explained in the Schedules and are summarised in the table below.

Table 4

No	PO's Finding	PO on Injustice	Government Response	Loss
2 & 4 3 &4 5	<p>The unreliability of the Returns</p> <p>GAD's failure to question and seek to resolve questions for each year from 1990 to 1993 (Finding 2) and from 1994 to 1996 (Finding 4), related to (i) the valuation rate of interest used to discount the Society's liabilities and (ii) to the affordability and sustainability of the Society's bonus declarations</p> <p>GAD's failure, when the introduction of the Society's differential terminal bonus policy was identified as part of the scrutiny of the 1993 returns, (i) to inform the prudential regulators about the policy, (ii) to raise the matter with the Society, or (iii) to seek to identify what the rationale was for the introduction of the policy and how it was being communicated to policyholders.</p> <p>GAD's failure to question and seek to resolve questions ... related to (iv) the holding of no explicit reserves for ... guaranteed annuity rates</p> <p>GAD's failure ... (ii) to pursue the information before them that the omitted information had led to the users of the returns misconstruing the financial strength of the Society [i.e. that Standard & Poor's 'AA' rating of Equitable was based upon a misunderstanding]</p>	<p>Injustice found, in respect of lost opportunities to invest elsewhere as a result of the misleading returns from July 1991 onwards.</p>	<p>The Government rejects the PO's findings of injustice.</p> <p>The Government maintains that, if GAD had asked the proper questions, then Equitable Life would have been able to justify its discounting of its mainstream pension business by up to one half and no change in the Returns and no injustice would have resulted.</p> <p>The Government accepts that the regulators should have identified the GAR problem when examining the 1993 Return and that provision for this liability should have been made for 1995 and 1996. Its argument is that the amounts involved did not become sufficiently material to affect policyholders' perceptions until much later.</p> <p>The Government claims that GAD had no duty to inform S&P of their error. It does not explain why GAD continued to use S&P's ratings in its own examinations, its own presentations to Ministers and in replying to questions.</p>	<p>£4,446m</p>
6	<p>Financial Re-Insurance</p> <p>The FSA's failure (i) to ensure that the financial reinsurance arrangement was not taken into account within the Society's 1998 returns without an appropriate concession being given, and (ii) to ensure that the credit taken by the Society within its returns for 1998, 1999, and 2000 properly reflected the economic substance of that arrangement</p>	<p>Injustice found, in respect of financial loss and lost opportunities to invest elsewhere for all those who joined the Society or paid a further premium that was not contractually required in the period after 1 May 1999.</p>	<p>The Government accepts the PO's finding of injustice, but claims that Equitable Life had other options to allow it to declare a bonus for 1998, without showing an unacceptable solvency position.</p>	<p>£355m</p>

THE GOVERNMENT'S VERBAL AND WRITTEN STATEMENTS

- 19 In Parliament, on 15th January, the Minister provided a verbal apology to policyholders, which on the face of it was unequivocal. The Minister's statement and the brief debate which followed revolved around various issues.
- a) **Relative Losses.** The Minister claimed that Government had not been able to estimate the cost of the Ombudsman's recommendation, based upon the losses sustained by Equitable Life policyholders, relative to how they would have fared by investment elsewhere.
 - b) **The appropriate proportion.** The Minister made much of Lord Penrose's statement that primarily the Society was the author of its own misfortunes. She sought to reduce the Government's contribution to any compensation package by reference to the proportion that the Society and others were to blame.
 - c) **The state of public finances.** The Minister sought to distinguish (and minimise) much-delayed compensation for a decade of regulatory failure in respect of Equitable Life from the immediate full compensation paid to investors in foreign banks, notable Icesave.
 - d) **Disproportionate effect.** The minister acknowledged that some policyholders or groups had been disproportionately affected by the maladministration in respect of Equitable Life. The Minister indicated that any compensation scheme would attempt to provide relief for those disproportionately affected.
- 20 The Minister announced the appointment of Sir John Chadwick to consider and advise upon these matters with a view to creating a 'fair ex gratia payment scheme' for those Equitable Life policyholders who have suffered a disproportionate impact. Those attending and observing the debate might be forgiven for receiving the impression that all those who had been badly affected by the Equitable Life debacle could eventually expect at least some form of compensation. Comment by Members of Parliament was mostly restricted to concerns about the timing of Sir John's advice.
- 21 However, the details of the written response (only published hours after the Minister sat down) make it clear that this impression is far from the truth. The paper, Command 7538, limits both the apology and Sir John Chadwick's consideration to:
- 'Those failures identified in the Ombudsman's report which are accepted in the Government's response' (Apology)
 - 'Those accepted cases of maladministration resulting in injustice' (Sir John's instructions)
- 22 It will be observed from the above, that while the Government accepts the PO's findings of maladministration, it mostly rejects her findings of injustice. This eliminates the vast majority of policyholders and the bulk of their losses (not less than nine tenths) from both the apology and from Sir John's considerations.
- 23 Relative Losses and Appropriate Proportion have already been included in EMAG's loss computations. However the Government's descriptions of 'Disproportionate Effect' and 'Public Finances' are too vague to quantify. The best we can say at this stage is that compensation is unlikely to exceed one twentieth of policyholders' actual losses.

THE PARLIAMENTARY OMBUDSMAN

- 24 The Government's rejection of the 'money' findings of injustice is not only a serious attack upon the quantum of policyholders' losses and compensation, but also an attack upon the person and institution of the Parliamentary Ombudsman. She and her team have spent 4 years proving beyond doubt that the Government's regulators failed Equitable Life's policyholders for more than a decade.
- 25 The Ombudsman is the mechanism set up by Parliament to investigate and if appropriate recommend redress for the constituents of Members, who have been harmed by maladministration. If the Government accepts her findings of maladministration, but rejects her findings of injustice and requires expert consideration of responsibility and loss computation, then surely its proper course is to refer these matters back to the PO?
- 26 Sir John Chadwick is a retired Appeal Court Judge, but in this instance he is merely acting as an advisor of the Treasury, itself found guilty through its sub-contractor the FSA, of 5 counts of maladministration. Sir John owes no duty to Parliament and reports privately to the Treasury. He is not required to hear representations from interested parties. Parliament has no control over the timing of his work. The 'Chadwick Process' falls a very long way short of the transparent and independent Tribunal recommended by the PO. The Government's action is arguably an insult to the Parliamentary Ombudsman and to Parliament.

CONCLUSIONS

- 27 As regards the 'money findings' the Government accepts virtually all the PO's findings of maladministration, but rejects virtually all her determinations that such maladministration led to injustice.
- 28 The Treasury seeks to appoint Sir John Chadwick to advise further, but has restricted his instructions so as to consider only those findings which the Government has accepted, eliminating at least 90% of policyholders' losses from his review.
- 29 However fair-minded Sir John Chadwick may be, the Treasury's instructions mean that the resulting compensation will be a very small fraction of the losses incurred by policyholders.

Equitable Members' Action Group

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EMAG is the only substantial Equitable Life policyholder group, with a proper constitution, a money subscription and an elected Board of Directors. It has received subscriptions from over 20,000 policyholders.

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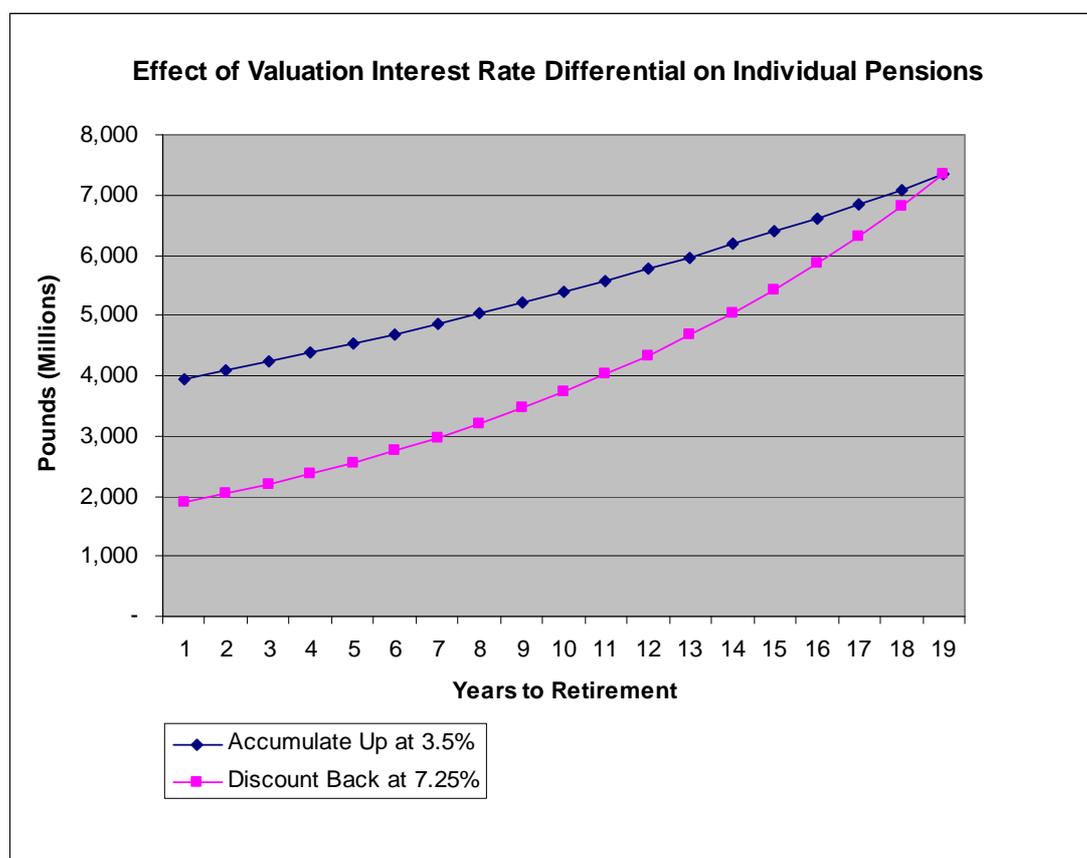
SCHEDULE 1 - VALUATION INTEREST RATES

Equitable Life's main line of business, representing about 80% of the with-profit fund, was the pension investment policy, that is, the accumulation of premiums during the policyholder's working lifetime to buy an annuity upon retirement. How this line of business was valued was far and away the most important aspect of the annual valuation of liabilities for regulatory purposes. By comparison, other issues should have paled into insignificance.

Policyholders, who received an annual statement showing how much their policy was worth, might reasonably have expected the regulators to use the contractual value shown on those statements (called the 'Guaranteed Policy Fund' or 'GPF'). However this was not the case. Throughout the period 1988 to 1999, the regulators allowed Equitable Life's actuaries to value such policies at a discount from the GPF, sometimes to a very substantial extent.

The largest differential was applied in respect of 1990. The chart below shows, in very simplified form, how the differential of 3.75%p.a applied over 18 years to the average retirement date reduced aggregate guaranteed policy values of just under £4,000m to liabilities for regulatory purposes of £1,900m.

The effect was like telling a policyholder that his guaranteed fund was £4,000, but telling the regulators that the Society only needed assets of £1,900 to cover it.



The PO found that GAD had identified that there was a problem, but failed to ask sufficient questions concerning:

The valuation rate of interest used to discount the liabilities, which appeared to be imprudent and/or impermissible (apparently discounting the liabilities well below the guaranteed face value of policies); and

The affordability and sustainability of the bonuses declared by the Society during this period, which appeared to raise the expectations of the Society's policyholders which, it appeared, could not be met.

The Government accepts this finding of maladministration.

As regards injustice the PO said:

One consequence of this failure was that the prudential regulators and GAD could not be satisfied that the Society was acting prudently and with proper regard to the interests and reasonable expectations of its policyholders. Another consequence of this failure is that the Society was never asked to justify whether it could afford its bonus declarations or how it proposed to sustain the level of bonus that it declared.

She concluded:

I find that injustice was sustained by any policyholder who relied on the information contained in the Society's returns for 1990 to 1996 and who suffered either a financial loss or a lost opportunity to take an informed decision as a result of such reliance. Where a policyholder neither relied on this information nor suffered a loss of either type, I find that no injustice resulted from this maladministration.

The Government rejects the PO's determination of injustice. In general terms the Government claims:

- a) that the valuation rates used were within the range allowed by the regulations
- b) that the use of an interest rate differential was allowed by the regulations
- c) that if GAD had raised the matter of sustainability of bonuses, then Equitable Life would have been able 'to establish that its approach to future bonuses was sustainable and affordable'

SCHEDULE 2 - THE GAR PROBLEM

The Society attempted to deal with the Guaranteed Annuity Rate problem in 1993 by means of changing its terminal bonus policy, so that the burden fell mostly upon policyholders instead of on the Society. GAD's failure to follow up the disclosure of the differential terminal bonus policy in the Return for that year meant that it did not discover the extent of the Society's exposure to the GAR problem or the fact that it had made no provision for this liability in its Returns.

The PO found that 'the failure by GAD, when the introduction of the Society's differential terminal bonus policy, intimated within the Society's 1993 returns, was identified by GAD as part of their scrutiny of those returns, (i) to inform the prudential regulators about the policy, (ii) to raise the matter with the Society, or (iii) to seek to identify what the rationale was for the introduction of the policy and how it was being communicated to policyholders constituted maladministration'

The Government only accepts part (i) of the PO's findings.

As regards injustice the PO said:

I consider that the loss of opportunities to take informed decisions about their financial affairs during the period from July 1994 to April 1999 in full knowledge of the exposure of the Society to guaranteed annuity rates and of the risks that such exposure generated constitutes injustice to policyholders and I consequently make a finding that policyholders suffered such injustice as a result of maladministration.

The Government rejects the PO's determination of injustice. In short, it contends that even if the regulators had raised the question of the GAR problem, none of the consequences envisaged by the PO would have actually transpired. These included, taking earlier legal advice, testing the policy earlier in the Court and making provision earlier in its Returns. The Government claims that in the absence of regulatory breaches, the influence of the regulators was limited.

As regards explicit reserves for the GAR cost in subsequent periods the PO found: 'that the failure, as part of the scrutiny process, to question and seek to resolve questions within the Society's regulatory returns for each year from 1994 to 1996, related to ... (iv) the holding of no explicit reserves for the liabilities associated with prospective liabilities for ...guaranteed annuity rates, constitutes maladministration by GAD;

As regards 1994, the Government believes interest rates were too low to justify making any reserve, but accepts this finding for 1995 and 1996.

The Government accepts that maladministration led to injustice, but claims that the amounts of the reserve were too small to have shown a significantly different picture. It does not say what, in its view, amounts of the GAR liability would have been.

EMAG's actuary has estimated the GAR liabilities for 1994, 1995 and 1996 as £346m, £435m and £483m respectively.

SCHEDULE 3 - THE TWO VALUATION METHODS

Equitable Life computed its actuarial liabilities (the value of policies in force) on a 'gross premium' basis in its Published Returns. This was acceptable so long as it could demonstrate that these, in aggregate, showed a higher, more conservative, liability than was required by the 'net premium' method required by the regulations. The Society submitted valuations using both methods, the regulatory version being shown in an Appendix. The resulting totals are shown below in lines A and C. This suggests that the Published version was more conservative than the Appendix one by a substantial margin; what we describe below as the 'Apparent Margin of Prudence'. In fact this was almost entirely illusory, since the Appendix version required a Resilience Reserve, which was not revealed in Returns. Indeed the Returns contained a note which could be read as meaning that no such Reserve was required. After taking into account the Resilience Reserve, the real Margin of Prudence was trivial.

Comparison of Actuarial Liabilities		1990	1991	1992	1993	1994
Appendix version	A	4,868	6,453	8,079	11,116	12,077
Resilience Reserve (not revealed in Returns)		450	390	462	236	171
	B	<u>5,318</u>	<u>6,843</u>	<u>8,541</u>	<u>11,352</u>	<u>12,248</u>
Published Version	C	<u>5,362</u>	<u>6,852</u>	<u>8,557</u>	<u>11,448</u>	<u>12,378</u>
Apparent Margin of Prudence	C-A	<u>494</u>	<u>399</u>	<u>478</u>	<u>332</u>	<u>301</u>
Real Margin of Prudence	C-B	<u>44</u>	<u>9</u>	<u>16</u>	<u>96</u>	<u>130</u>

For the years 1990 to 1994, GAD asked Equitable to supply to it the Resilience Reserve figure, included in the table above. This meant that GAD could satisfy itself that the valuation method which the Society used was indeed more conservative than that required by the regulations, albeit not by much.

The effect of this charade was that GAD complied with the rules, but allowed Equitable to present to the outside world a misleading impression of conservatism, clearly against the spirit of the 'freedom with publicity' policy advanced by Ministers.

The ratings agency, Standard & Poor's first considered Equitable in 1993, when the Society received an 'AA (Excellent)' rating, which it continued to receive until May 1999. Companies which were given such a rating by Standard & Poor's were described as offering 'excellent financial security'.

It subsequently became clear to GAD that Standard & Poor's had been misled. The PO said:

[S&P's] ratings demonstrated that the Society's method of presenting the two valuations, but without including the figure for the resilience reserve, was being misconstrued.

GAD knew that, contrary to the information contained within Standard & Poor's ratings, Equitable did not adopt a conservative valuation approach – quite the opposite.

GAD also knew that, contrary to the information within those ratings, there was little difference between the results of the Society's alternative method of valuation and the minimum prescribed in the Regulations. In substance, there were no margins, as had been wrongly assumed, between the statutory minimum reserves and the results which the Society's alternative method had produced.

The way in which the Society presented its returns – and was permitted to present its returns – led directly to financial analysts misunderstanding the true financial condition of the Society and to misleading information being disseminated about the 'hidden' strengths of the Society's position. Yet GAD failed to take any action concerning this matter.' Chapter 10, paragraphs 374-377.

She concluded:

'While I accept that the prudential regulators and GAD were not responsible for the content of the ratings produced by such agencies, that does not explain why the Society's ratings – despite them containing assessments which GAD should have known were fundamentally flawed – were used by GAD and by the prudential regulators in a number of contexts – such as in scrutiny reports, as briefing for Ministers and to deal with enquiries as to the strength of the Society.

I consider that GAD should have alerted the prudential regulators to the issue and should have recommended that those ratings should not be used as briefing material and to respond to enquiries.' Chapter 10, paragraphs 393-395.

Her finding was that the failure:

'to pursue the information before them that the omitted information had led to the users of the returns misconstruing the financial strength of the Society constitutes maladministration by GAD;

The Government does not accept that either GAD or the regulator was under any duty to act in response to the credit rating produced by Standard & Poor's.

As regards injustice the PO said:

'That maladministration resulted in the reader of the returns not having the information that was before GAD and which, arguably, should have been available to all readers of the Society's published returns. No action was taken when it was clear that those readers [S&P] were misconstruing the information that was provided. Maladministration also resulted in those who expressed concerns about the Society's solvency being reassured on grounds which were not sustainable.' Chapter 12, paragraphs 34-37.

The Government rejects that any injustice derived from this finding of maladministration. Its reasons are technical justifications for GAD's doing nothing when it ascertained that Standard & Poor's had made a mistake. It does not explain why GAD continued to use their ratings in its own examinations, in its own presentations to Ministers and in replying to questions.

SCHEDULE 4 - FINANCIAL RE-INSURANCE

This is the most blatant case of maladministration. The Treasury and the FSA bent over backwards to allow Equitable to take £800 million/£1,000 million credit for a reinsurance policy that they knew was worthless. The PO made a finding of maladministration against the FSA. The PO found that this injustice led directly to financial loss.

This finding applies to new policies taken out and new investments made after 1 May 1999. As the bulk of Equitable Life's business was of a single premium type, almost all subsequent premiums totalling about £3,500m are covered by this finding.

This is of particular interest since those who invested after 1 May 1999 got back substantially less than they paid in. Their investments received hardly anything in bonuses (certainly nothing in terms of excess bonuses) and the 16% policy cut was applied to them regardless of that fact. Many suffered further penalties when they tried to mitigate their loss by removing their funds from Equitable.

The PO's finding in this regard has the happy effect of providing a compensation route for those who suffered from other areas of complaint over the same period e.g. the FSA's inaction in respect of the GAR litigation and its failure to demand special consideration for those who joined after the House of Lords decision.

The facts are relatively straightforward.

The Treasury took over prudential regulation from the DTI in 1998 and soon identified Equitable Life as a problem case, particularly as regards its, by that time, serious GAR liability, estimated at £1.6bn. It was clear that inclusion of such a liability in the 1998 Returns would threaten the Society's solvency to the point of putting at risk its 1998 bonus declaration, omission of which was recognised as commercial suicide. A meeting was held with the Society even before that year had ended at which this serious situation was discussed. Re-insurance was mentioned as a possible means of relief. The Treasury expressed its willingness to grant a concession allowing credit to be taken for such re-insurance, even if it could not be actually completed by 31 December 1998.

The FSA took over most aspects of prudential regulation as the Treasury's sub-contractor from January 1999.

The Society then arranged a form of re-insurance with an Irish company for a premium of (initially) £150,000. This was claimed by Equitable Life as an asset worth £800 million. GAD examined the transaction and found it insufficient to justify such a credit. Regardless of GAD's view, the FSA's Director of Insurance and Managing Director told their Board that satisfactory re-insurance cover had been arranged and the Society declared its 1998 bonus in March 1999 in the usual way.

The actual re-insurance treaty was not signed until October 1999 and the Treasury never issued any concession to allow back-dating to 1998. Credit for this treaty was allowed in the 1998 and subsequent returns of the order of £800-1000m.

The PO concluded:

'that the failures (i) to ensure that the financial reinsurance arrangement was not taken into account within the Society's 1998 returns without an appropriate concession being given, and (ii) to ensure that the credit taken by the Society within its returns for 1998, 1999, and 2000 properly reflected the economic substance of that arrangement constitutes maladministration by the FSA.'

As regards injustice the PO said:

I consider that the maladministration relating to the acts and omissions of the FSA in permitting the Society to take the credit that it did for the financial reinsurance arrangement within the Society's 1998 regulatory returns, which were available to the public by 1 May 1999, constituted a significant turning point. Those acts and omissions represent, in my view, a critical juncture in the sequence of events which I have recounted in this report.

That the Society was permitted by the FSA to take any credit within its 1998 returns, without the required concession, had significant consequences. That was reinforced by the fact that the credit that was taken with the permission of the FSA totalled £809 million – despite the fact that, had regard been had, as it should have been, to the economic substance of the arrangement, no credit would have been permissible at all.

The Society's 1998 returns were available to the public by 1 May 1999. Had the FSA acted, as they should have done, they would have ensured that the financial reinsurance arrangement was given no credit within those returns, with all the ramifications that this would have had on the reported financial position of the Society.

I consider that, in those circumstances and on the balance of probabilities, if the Society had sought to declare either a reversionary bonus or a terminal bonus in March 1999, the FSA would have taken action to prevent the declaration from taking effect, on the grounds that such a declaration would have adverse effects for the reasonable expectations of the Society's policyholders if it were later to be reduced.

Any failure to make such a bonus declaration was recognised, at the time, to be 'commercial suicide' by both the regulatory bodies and the Society itself. Whether or not in fact the Society did declare a bonus, the Society's published regulatory solvency position would have been very weak at that point. This would have occurred in a context in which the Society's serious financial position was not yet generally known to the public.

Once that financial position became known, I consider that many fewer new prospective policyholders, acting reasonably, would have taken out with-profits policies with the Society. The Society's financial position would have become known shortly after the Society announced, as it would have had to do, that it was not declaring a bonus. If in fact it did declare a bonus, its financial position would have become known by 1 May 1999, when the Society's 1998 returns were published. I also consider that many fewer existing policyholders would have taken out a with-profits annuity, from which there was no subsequent prospect of exit.

Furthermore, I consider that many fewer existing policyholders would have made further contributions to existing policies in the circumstances which would have prevailed had this maladministration not occurred.

She concluded:

146 I find that, in respect of all those who joined the Society or paid a further premium that was not contractually required in the period after 1 May 1999, any financial loss that they have sustained constitutes injustice in consequence of maladministration. Those affected by that maladministration have also suffered injustice in the form of lost opportunities to take informed decisions about their financial affairs. Chapter 12, paragraphs 133-146.

The Government accepts the Ombudsman's findings of maladministration and injustice in relation to Equitable Life's use of reinsurance, but seeks to suggest that the consequences would not have been as serious as envisaged by the PO.

The Government claims that Equitable Life had other options to allow it to declare a bonus for 1998, without showing an unacceptable solvency position. These include 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'.

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.

This is an attempt to mitigate the financial consequences to the Treasury of the Government's acceptance of both maladministration and injustice in respect of the Financial Re-Insurance arrangement.