



# A Further Investigation of the Prudential Regulation of Equitable Life?



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of the Parliamentary Commissioner Act 1967

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# Parliamentary Commissioner Act 1967

## A further investigation of the prudential regulation of Equitable Life?

### Introduction

1. I am laying this report before both Houses of Parliament, pursuant to section 10(4) of the Parliamentary Commissioner Act 1967, because I consider this to be in the public interest. The report sets out my decision on whether to conduct a further investigation into the prudential regulation of the Equitable Life Assurance Society (Equitable Life) and the reasons for that decision. This fulfils my commitment to announce my decision before the Parliamentary recess. I am also sending a copy of this report to everyone who contacted me during my recent consultation exercise.

### Background

2. The report of my investigation into the prudential regulation of Equitable Life was laid before Parliament on 30 June 2003. That report covered the discharge by Her Majesty's Treasury and by the Financial Services Authority (FSA) - on behalf of Her Majesty's Treasury - of the prudential regulation of the Society during the period from 1 January 1999 to 8 December 2000. That investigation was of a representative complaint - one of the approximately 340 complaints then referred by Members of Parliament to me or my predecessor. By 1 July 2004, my Office had received 599 referred complaints about Equitable Life. After I had reported in June 2003, I stated that I would give further consideration to the position following publication of the report of the Penrose inquiry and the response of the Government to that report and would give a decision, with supporting reasons, as to whether I would carry out any further investigation.

3. On 8 March 2004 the Treasury published the report of the inquiry it had commissioned on 31 August 2001, conducted by the Lord Penrose, the terms of reference for which were:

*To enquire 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; and to give a report thereon to Treasury Ministers.*

4. I wrote to all Members of Parliament on 16 March 2004 to advise them that, in order to inform my decision on whether I should conduct any further investigation into the prudential regulation of Equitable

Life in the light of the Penrose report, I would consult interested parties. That consultation, on whether my Office should carry out a further investigation and, if so, over what period and with regard to which matters, was launched on 22 April 2004.

### The consultation exercise

5. As part of the consultation process, I invited representations from all Members of Parliament, from the policyholders whose complaints my Office held on file, from representative policyholder action groups, from relevant government bodies, from the Public Administration and Treasury Select Committees and from the opposition parties. I also placed notices in the national, regional and ethnic press seeking representations from any interested party.

6. Annex A to this report provides aggregate information about the representations I received by the end of May 2004. I received approximately 2,000 responses, including 211 from Members of Parliament, 1,603 from policyholders or former policyholders, three from policyholder action groups, and responses from Equitable Life, the Treasury, FSA, the Government Actuary's Department (GAD) and the Department of Trade and Industry.

7. Annex B contains the principal written submissions I received - reproduced either in full or in edited versions. I regret that I have been unable to secure the permission of the Government Actuary for publication of his written submission as he is out of the country until 21 July. However, his submission did not make a representation on whether I should conduct a further investigation but was confined to his position in relation to the findings of the Penrose inquiry. I make no comment on each submission - in my view they speak for themselves. In coming to my decision, I have considered all of the responses and submissions received.

8. As part of the consultation, I also invited Equitable Life, the Equitable Members' Action Group (EMAG), Lord Penrose, the Treasury, FSA, GAD, the Financial Ombudsman Service, and representatives both of the Official Opposition and of the Liberal Democrats to meet me, so that I might hear their views direct.

9. As can be seen from his response in Annex B,

Lord Penrose felt unable to meet me and has expressed the view that, as a serving judge, he can make no further contribution to these matters. I met the other key parties, with the exception of GAD, in a series of generally constructive meetings in late May and June 2004. The meeting with Equitable Life was particularly welcome, as their written response to my invitation was the first communication I had received directly from the Society on these matters.

10. My decision has been informed by consideration of the complaints referred to me or my predecessor since 2001, by the contents of the Penrose report, and by the written and oral representations submitted to me as part of the consultation exercise I conducted following the publication of that report.

11. However, before setting out my decision on whether to conduct a further investigation of the prudential regulation of Equitable Life, and the reasons for that decision, I will set out the tests that I apply to any complaint to determine whether it is one that I could and should investigate. This I do to place my decision in context.

## Assessing whether I can and should investigate

12. When considering whether I should investigate a complaint referred to me by a Member of Parliament, I make four assessments.

13. First, I determine whether the body (or bodies) complained about are **within my jurisdiction** and, if so, whether the actions that form the subject of the complaint are ones within my remit. While I understand why a perception might have arisen that I have jurisdiction over anything done by any government or other public body, that is not the case. I may only investigate the administrative actions of those bodies listed in Schedule 2 to the Parliamentary Commissioner Act 1967 (the 1967 Act) - or those acting on behalf of such a body, if those actions are taken in the exercise of the listed body's administrative functions. Furthermore, I may not consider complaints about the actions of bodies within my jurisdiction where such actions are of a type specifically excluded from my remit, principally by Schedule 3 to the 1967 Act. Neither can I consider complaints where I believe that an alternative remedy is available to the complainant through the courts or a statutory tribunal, unless I am satisfied that in the particular circumstances it is not reasonable to expect the complainant to resort or have resorted to that alternative remedy.

14. Secondly, assuming that both the bodies and matters complained about are ones that I have the legal power to investigate, I then assess whether I have been shown any **prima facie evidence of maladministration** by the relevant body or bodies. Many people come to my Office with a profound sense of outrage at the content of government policy or by the effects on them of the relevant legislative framework. However, I am not

empowered to question the merits of legislation or of government policy formulated without maladministration or to question the merits of a decision taken without maladministration by a government department or other body in the exercise of a discretion vested in that department or body.

15. Thirdly, if it appears to me that there is evidence pointing to administrative fault on the part of the body or bodies complained about, I consider whether it appears that any such maladministration, if established, may have **caused an unremedied injustice** to the person making the complaint. However strongly felt a sense of outrage or injustice may be as a result of what appears to be administrative error, if other factors have caused the injustice complained about, then it is not for me to investigate such complaints.

16. Finally, I consider whether an investigation by my Office may produce a **worthwhile outcome** to the complainant. This might be achieved by the production of a suitable remedy, which can comprise an apology, improvements to administrative systems, or financial redress, or by the provision of an authoritative explanation of past events or the resolution of outstanding issues.

17. There are three important principles underpinning the work of my Office should I decide, on the basis of the tests described above, that a statutory investigation of a complaint, or of part of a complaint, is appropriate.

18. I consider that it is particularly important on this occasion for me to set these principles out as clearly as possible:

- first, my Office is **impartial** between the parties to a complaint: I am neither advocate for the complainant nor apologist for those under investigation. I always seek to conduct a rigorous and independent scrutiny of the relevant events in the light of all of the available evidence. If injustice caused by maladministration is found, I consider it the role of my Office to pursue appropriate redress vigorously;
- secondly, my approach to any investigation **cannot benefit from the use of hindsight** or be influenced by my personal opinion - or that of my staff - on what *should have been* the relevant statutory or policy frameworks. I cannot substitute my view as to what would have been an appropriate policy or consider the merits of a decision taken without maladministration. Instead, I assess whether the relevant public body did what it ought to have done; whether it did anything that it should not have done; and whether it otherwise acted without maladministration; and
- thirdly, a decision to conduct an investigation does **not mean that I have prejudged the outcome** of that investigation. My initial assessment is based on the often limited material available when the complaint is

put to me and on whether such material discloses indications that maladministration might have occurred. A decision that a complaint is worthy of investigation does not mean that a finding of maladministration causing injustice will follow. The outcome of a detailed investigation by my Office may be that I do not uphold the complaint.

## Decision

19. In the light of the evidence before me and, having applied the tests described above to that evidence, **I have decided, subject to what I say in paragraph 20 below, to conduct a statutory investigation of the prudential regulation of Equitable Life in the period prior to 2 December 2001.**

20. That investigation will focus on the actions (including failures to act) of the government departments responsible under the relevant legislation for the prudential regulation of Equitable Life. My investigation will, subject to approval of a request I have made of the Government (Annex C), also include the actions of GAD, for reasons that I explain below. **However, should approval of my request not be forthcoming, I will, in the absence of the ability to consider the actions of GAD, review my decision to investigate.**

21. The rest of this report deals with the scope of my decision - the bodies whose actions I propose to investigate and the time period to be covered by my investigation - and the reasons for my decision. The report will also outline the next steps that I propose to take.

## Scope of my decision

### Jurisdiction

22. It is evident to me - from the substance of many of the complaints about Equitable Life referred to me, from many of the representations I received during the consultation process and from press and public comment - that my jurisdiction in relation to the events at Equitable Life is not understood by many people.

23. Many of the complaints and representations I have received concern the actions of Equitable Life itself, the actions of its salesforce and directors, or are about the Society's auditors or accountants. I must make it very clear again that I have no role in considering complaints about mis-selling of policies or about the conduct of the Society. Neither do I have the power to investigate the actions of the FSA, except where it acted on behalf of the Treasury from 1 January 1999 to 2 December 2001, as it is not listed in Schedule 2 to the 1967 Act (paragraph 13). Nor are the actions and judgment of the House of Lords, which I have been asked by some people to 'review', within my remit.

24. My staff will, over the coming weeks, identify those complaints on file and those representations made in the consultation process which raise issues outside my jurisdiction. We will then write to those individuals to

ensure that they are aware of the extent of my remit and, where appropriate, we will identify which other bodies might assist them.

25. I will now outline my current jurisdiction in relation to the regulators of Equitable Life and the reasons why I have asked the Government to empower me to investigate the actions of GAD in relation to the prudential regulation of Equitable Life. I will also deal with the request that has been made to me that I should consider asking that the conduct of business regulators - that is, those responsible for overseeing the sale of policies to individuals and for sales communications between Equitable Life and its potential and existing policyholders - are brought within my jurisdiction.

### The prudential regulator

26. I have jurisdiction to investigate the administrative actions of those government departments - the Department of Trade and Industry and the Treasury and their Ministers - responsible in law for the prudential regulation of life assurance companies before 2 December 2001. Both of these bodies were at all the relevant times listed in Schedule 2 to the 1967 Act. The focus of my further investigation will include the actions of those Departments.

### The Government Actuary's Department

27. I consider, and am advised, that GAD is not within my jurisdiction. It is not listed in Schedule 2 to the 1967 Act and, indeed, the Notes on Clauses on the Act, prepared at the time of its passage through Parliament, clearly demonstrate an intention to put GAD outside my jurisdiction.

28. That said, it has been put to me in some of the key representations I have received that any future investigation by my Office should include the actions of GAD. Indeed, EMAG put it to me in their written submission (Annex B) that 'any further investigation would be meaningless without such jurisdiction'.

29. My decision to ask for the inclusion of GAD within my jurisdiction has been informed by the assessments of the role and performance of GAD, made with the benefit of hindsight, in the Penrose report. These assessments may or may not be correct but they provide material that makes it arguable that there was maladministration by GAD. Examples include:

- the 'key finding' of Lord Penrose that 'there was a general failure on behalf of the regulators and the GAD to follow up issues that arose in the course of their regulation of the Society' (paragraph 240 (11) of chapter 19); and
- Lord Penrose's specific assessment that 'although GAD brought in a more detailed style of scrutiny in the early 1990s, the standards of scrutiny still impress me as complacent, lacking challenge and

hesitant in criticism and in following up on any criticism made. This was, indirectly, reflected in a lack of robustness in the regulatory process' (paragraph 160 of chapter 19).

30. These observations by Lord Penrose seem to me to indicate that the advice provided by GAD, and the actions it took in support of that advice, may have been important to the way in which the prudential regulator undertook its functions. In addition, Lord Penrose's criticisms of GAD might indicate that GAD was, at least arguably, maladministrative in performing its functions.

31. I recognise - as does Lord Penrose himself - that Lord Penrose was applying different tests in relation to GAD to the ones that I must apply, and that his approach was informed by hindsight. I also recognise that the role of GAD has changed substantially since 26 April 2001, when its role in relation to advising the regulators of the insurance industry was transferred to the FSA. I am also aware that some of the current work of GAD is not of the type normally subject to my scrutiny.

32. However, I consider that there is sufficient initial evidence to suggest that the actions of GAD are key to an assessment of whether maladministration by the prudential regulator caused an unremedied injustice to complainants. I believe therefore that GAD's actions must be brought within my jurisdiction if my investigation is to be meaningful.

33. I consider that the recent change in GAD's responsibilities does not constitute an insurmountable problem. As explained in my letter requesting the addition of GAD to my jurisdiction (Annex C), if it is considered that such an addition by Order in Council would be undesirable in relation to GAD's current responsibilities, the relevant entry in Schedule 2 to the 1967 Act could be accompanied by a Note to that Schedule. This Note could limit my jurisdiction to GAD's actions before 26 April 2001.

### Conduct of business regulation

34. It has been put to me - not least by EMAG - that I should also consider whether my jurisdiction should be extended to include those bodies responsible prior to December 2001 for the regulation of the conduct of life insurance companies' business.

35. I understand why this is considered important. Many of the representations I received during the consultation exercise - and the referred complaints we hold on file - focus on conduct of business issues. Such complaints particularly concern alleged mis-selling, alleged failures to provide clear information to existing and prospective policyholders, and the performance of the regulatory bodies in exercising their responsibility to oversee such matters.

36. However, I am advised that the relevant regulatory bodies - the Designated Agency to which the Secretary of State transferred his responsibilities, the

Securities and Investments Board (SIB - now renamed the FSA), and the self-regulatory organisations (particularly the Personal Investment Authority) - are not bodies which can be brought within my jurisdiction by Order in Council.

37. Section 4(3) of the 1967 Act provides that only public bodies that meet certain criteria can be added to my jurisdiction by Order in Council. Bodies not meeting these criteria - which include the SIB-FSA and the now-defunct self-regulatory bodies - could only be added to my jurisdiction by primary legislation.

38. While the Government has said that it will consider a request from me for the addition of GAD to my jurisdiction, it has made no such statement in relation to the conduct of business regulators. Moreover, I do not think that it would be in the public interest - or in the interest of policyholders - to delay my investigation with the aim of bringing the conduct of business regulators within my jurisdiction.

39. Furthermore, while many people have suggested that it would be desirable for me to have jurisdiction over those bodies historically responsible for regulating conduct of business matters, it does not appear to be a widely-held view that the absence of such powers would render worthless any investigation conducted by me.

40. In any case, my powers to obtain evidence, under sections 8 and 9 of the 1967 Act, are wide. I would use those powers to interview witnesses and examine documents related to conduct of business matters should I consider that that would assist my investigation.

### Timeframe of investigation

41. Respondents to the consultation suggested a number of timeframes for any future investigation:

- most Members of Parliament and many policyholders suggested that any further investigation by me should cover the same period as that covered by the Penrose report;
- the action group representing with-profits annuitants suggested that any investigation should start 'at least from 1973' as this was the time they allege that 'Equitable's estate began to be dispersed';
- EMAG suggested 'at least from 1987'; and
- some MPs and individual policyholders suggested that 'no artificial limits' should be placed on the time-frame for any investigation.

42. I recognise that all of the timeframes outlined above are based on an assessment of when Lord Penrose suggests that Equitable Life's problems originated. I am minded to focus on events relevant to the closure of Equitable Life to new business. I propose to invite further representations on this point. In the interests of fairness,

I shall keep in the forefront of my mind the impairment of recollection - which is the inevitable consequence of the passage of time since the material events - and the extent of the availability of material documentation.

43. That said, I have no jurisdiction over the actions of the prudential regulators on or after 2 December 2001 and therefore my investigation must conclude at the latest with that date. I will revisit the findings of my first report in the light of the inclusion of GAD within my jurisdiction, should approval of my request be forthcoming, and in the light of the evidence disclosed by my proposed second investigation.

### *Prima facie* evidence of maladministration

44. As explained in paragraphs 1 and 2 of Part I of my first report to Parliament, *The Prudential Regulation of Equitable Life*, many of the complaints about Equitable Life referred to me or my predecessor by Members of Parliament were about matters that were not within my jurisdiction.

45. In addition, many complaints, understandably, disclosed more information about the perceived injustice suffered by complainants than about any alleged maladministration, by bodies in my jurisdiction, which may have caused this injustice.

46. When seeking to identify whether there is sufficient material before me to indicate that there may have been maladministration on the part of the prudential regulator and GAD, I have sought to focus my attention on two principal sources: the Penrose report and the representations made to me in the consultation exercise.

#### Penrose

47. I do not intend to repeat here all of the criticisms of the regulators contained in the Penrose report - or begin to assess whether these were directed at the adequacy of the regulatory system or towards operational failures by regulators. I will consider all of the relevant material in that report as part of my investigation.

48. However, I consider that the general criticisms of prudential regulation made by Penrose (in addition to those mentioned above at paragraph 29), which can be viewed as *prima facie* evidence of maladministration, include:

- **that the regulators were not adequately resourced to fulfil their obligations:** the 'DTI insurance division was ill-equipped to participate in the regulatory process. It had inadequate staff, and those involved at the supervisor level in particular were not qualified to make any significant contribution to the process... were not individually equipped with specific relevant skills or experience to assess independently the Society's position' (paragraph 158 of chapter 19);

- **that the regulators as a result did not properly undertake their functions:** 'it is difficult to avoid the view that regulation was falling between two stools, the major player in discussions having no regulatory power and the empowered regulator having little part in the processes that would have instructed regulatory action' (paragraph 252 of chapter 16);

- **that on several specific occasions information that might have led to regulatory action was ignored or not actioned by the regulators or GAD** (examples throughout the report);

- **that the regulators and GAD allowed the chief executive of Equitable Life also to hold the post of appointed actuary:** 'regulation was based on an over-reliance on the appointed actuary who... was also the chief executive over the critical period from 1991 to 1997, despite a recognition for the potential for conflict of interest inherent in this position' (paragraph 240 (7) of chapter 19);

- **that the regulators and GAD did not keep pace with developments in the industry** and that thus 'regulatory solvency became an increasingly irrelevant measure of the realistic financial position of the Society';

- **that the regulators and GAD did not properly assess the impact and adequacy of measures being used to improve Equitable Life's solvency position:** 'the regulators... failed to give sufficient consideration to the fact that a number of the various measures used to bolster the Society's solvency position were predicated on the emergence of future surplus' (paragraph 240 (10) of chapter 19); and

- **that the regulators and GAD failed to assess the reasonable expectations of policyholders in terms of the effect of these on Equitable Life's ability to meet its liabilities or to assess properly the impact of the House of Lords' judgment:** 'there was... no consistent or persistent attempt to establish how [Policyholders' Reasonable Expectations] should affect the acknowledged liabilities of the Society' (paragraph 240 (9) of chapter 19) and 'it appears that the regulators proceeded on the assumption that, if anyone were disadvantaged by the [Court's] decision, compensation would be available' (paragraph 115 of chapter 18).

#### Other criticisms

49. EMAG, in their formal submission and in the template letters prepared for their members and supporters, also made the following specific criticisms of the regulators and GAD:

- 'Equitable were permitted by the various Government regulators to publish financial results and projections that were grossly misleading to its members and to prospective new customers';

- that the regulators were aware of the true, weak financial position of the Society - for example, it is alleged that GAD knew about the 'practices of dubious actuarial merit' employed by the Society as far back as 1990 - and 'did nothing about it and by their silence connived in the Equitable Board's misleading representation of its finances';
- that the regulators permitted over-bonusing 'which was a contributory factor in the Society's demise and in the losses sustained by those who held policies on 16 July 2001' and 'did not identify that guaranteed annuity rates would become a problem'; and
- other 'questions raised by Lord Penrose's report', as set out in Part IV of EMAG's written submission (Annex B).

50. Andrew Tyrie MP, in his submission on behalf of the Official Opposition (Annex B), concurred with much of the above, as did the Liberal Democrats in their submission. Mr Tyrie also said that the regulators 'failed to recognise the inadequacy of the reinsurance policy negotiated to cover reversionary bonuses for [Guaranteed Annuity Rates] in late 1998 and early 1999'.

51. In my view, the criticisms contained in the Penrose report and the evidence put forward by the action groups and by opposition spokespeople constitute sufficient material to warrant an investigation into the way in which the prudential regulators and GAD discharged their responsibilities.

### Unremedied injustice

52. It is very clear to me that many thousands of policyholders and former policyholders feel greatly aggrieved by events at Equitable Life. When reading the 1,603 representations from individual policyholders, I could not but be struck by the considerable distress caused by these events to many people from very diverse backgrounds, not all of whom have other sources of income.

53. The representations I received cited significant financial hardship and loss caused, in particular, by cuts in annuity rates and in the value of individual policies and pension funds. One respondent said that he had lost almost 40% of his savings; another that more than 35% of her income had been lost as a result of the cuts progressively imposed since July 2001 on Equitable Life annuities. These individual stories are not by any means unique. The consultation process gave me a valuable opportunity to hear directly from the many people most acutely affected by the situation at Equitable Life.

54. I have received many representations, describing the situations in which individual policyholders now find themselves - whether suffering reduced current income, a likely reduction in future retirement income, or uncertainty and financial instability - and the outrage felt

by many at the events that precipitated these situations. Most of these share a sense of anger that government bodies did not protect them from the unfolding events.

55. Section 5 of the 1967 Act allows me to consider complaints in cases where a member of the public **claims** to have suffered an injustice in consequence of maladministration by a body in my jurisdiction. It is clear to me, from the individual representations I have received, that a large number of people claim to have suffered such an injustice, which they believe has been caused by maladministration on the part of the prudential regulators and GAD.

### Worthwhile outcome

56. I now turn to the arguments about whether a further investigation by my Office would be likely to provide a worthwhile outcome.

### Arguments for my intervention

57. During the consultation process, there were broadly five arguments put forward in favour of my conducting a further investigation:

- first, it was suggested to me that **only** the Parliamentary Ombudsman has sufficient standing and expertise to adjudicate on whether maladministration by government bodies has caused an injustice to individual citizens. Therefore, a further investigation by me was necessary to resolve this question;
- secondly, it was put to me that, even were this not the case, Lord Penrose either could not, or chose not to, address questions of maladministration and of redress for any such maladministration, although he had identified instances of regulatory failure - and that, accordingly, only I could **now** recommend compensation from public bodies;
- thirdly, it was submitted that, although my remit might be limited to certain government bodies, there were no alternative remedies available to policyholders for regulatory failure. It was unreasonable to expect them to pursue the one potential alternative course of action - uncertain and costly litigation against the Government or the regulators;
- fourthly, it was argued that, unless finality was brought to the Equitable Life affair, public confidence in the financial services industry would continue to be eroded and younger generations would be dissuaded from investing in pension provision; and
- finally, it was put to me that a failure to act would lead to a loss of public confidence in, and respect for, my Office and that this would reflect badly more generally on the wider reputation of Parliamentary oversight of government bodies and of the protection afforded to consumers by Parliament.



## Arguments against my intervention

58. Six broad arguments were put to me as reasons for not conducting a further investigation:

- first, it was suggested that to conduct a full investigation would be costly to the public purse, involve complex matters about which my Office was not best placed to make judgments, and would take many years to complete;
- secondly, it was argued that other bodies - principally the courts or the Financial Ombudsman Service (and the Financial Services Compensation Scheme) - were more appropriate channels for resolving individual claims or complaints;
- thirdly, it was put to me that my jurisdiction was so limited as to make any worthwhile outcome impossible and that I would only be raising expectations falsely were I to conduct a further investigation;
- fourthly, it was suggested that there was no evidence of operational regulatory failure but rather failure of an inadequate *system* established by Parliament - matters about which it was said that I could not comment, or on which I could not adjudicate;
- fifthly, it was put to me that to conduct a further investigation would be 'oppressive' to the staff and former staff of regulatory bodies who would have to undergo a fourth scrutiny of the same matters (the Baird report, my first investigation, and the Penrose inquiry being the other three) and would, for the FSA in particular, be a distraction from its current core business; and
- finally, it was suggested that, by conducting a further investigation, I would be 'opening the floodgates' to a range of other complaints about failures in the financial services industry and allied sectors, which would divert my Office from its core business.

## The Penrose report as the basis for my investigation

59. Before detailing my assessment of each of the principal arguments put to me as outlined above, I wish to deal with one related aspect of some of the representations I have received - namely, the degree to which the Penrose report provides a factual basis on which to draw upon in my investigation.

60. The choice before me is either to conduct a further statutory investigation of the relevant events or not to conduct any such investigation. Where Government Departments or officials accept findings of fact by Lord Penrose, this may shorten my process of investigation. However, I cannot, as has been suggested by some, simply take the Penrose report as 'findings of fact' and

then apply an assessment of whether those 'findings' disclose maladministration on the part of the prudential regulators and GAD.

61. Lord Penrose, when introducing his conclusions in paragraph 2 of chapter 19 of his report, said:

*As throughout this report, I have not qualified my comments by reference to professional standards current at the time events occurred: that is a matter for the courts and the professional bodies exercising disciplinary functions. Further, I have the benefit of hindsight, and I have not restricted the comments made to those matters that can be shown to have been within the knowledge or contemplation of individuals or groups at material times. In seeking material from which lessons can be learnt for the future it would be impossible to restrict oneself to what individuals knew or ought to have known at any time in the past.*

62. However, that is exactly what I must do: abandon hindsight and assess whether the actions of the bodies under investigation complied with the relevant statutory and regulatory provisions current at the time. In his letter to me (Annex B), Lord Penrose himself recognises this critical difference:

*In carrying out your function you will, I think inevitably, have access to different evidence from the evidence I had available, and the issues you will have to consider, within the terms of your remit, will, equally inevitably, be different from those that engaged my attention as reporter. It would have been, and remains, outside the scope of my remit as reporter to form and express views on the issues you have to consider.*

63. In addition, the representations I have received make it clear that key parties to the relevant events do not accept that Lord Penrose's narrative is correct in important respects and/or represents an undisputed understanding of events.

64. Thus, while I would have regard to all relevant evidence, including the papers of the Penrose inquiry, I have to conduct a full, statutory investigation based on the approach I have outlined in paragraph 18 above.

## Assessment

65. Turning first to the arguments put forward in favour of a further investigation by my Office, as set out in paragraph 57 above, it is clear to me, with respect to the first two arguments, that the Penrose report did not - for whatever reason - deal with questions of maladministration or of redress. Given my statutory function, I find the arguments that only the Parliamentary Ombudsman can now address such complaints, and

deliver a verdict on whether maladministration has occurred, highly persuasive.

66. I recognise that there are other potential remedies available to policyholders with respect to the other actors central to events at Equitable Life. For example, there is legal action by Equitable Life pending against the Society's former directors and auditors and the Financial Ombudsman Service is dealing with thousands of complaints about mis-selling by the Society's staff. I also understand that action groups are considering legal action against the Society in relation to the position in which with-profits annuitants find themselves. However, it does not seem to me reasonable to suggest that individual policyholders, often now in straitened financial circumstances, should be expected to take uncertain and expensive legal action against the prudential regulators or GAD. My Office was created to provide access to administrative justice that is free to those seeking it and I can see no reason why the existence of courts, whether domestic or European, should preclude me from assisting citizens whose complaints are ones that I can investigate. Moreover, I am not persuaded that an alternative remedy exists in those courts to which it would have been reasonable, in these particular circumstances, to expect the complainants to resort or to have resorted. The legal advice to me, in relation to the prudential regulators, is that those with a claim to have suffered an injustice in consequence of maladministration are unlikely to have *any* legal remedy available to them.

67. In relation to the arguments about public confidence both in my Office and in the financial services industry and about the protection afforded to consumers by Parliament, I have some sympathy with the latter arguments. However, I do not think that it is necessary to deal with them in detail here as the other arguments I have already discussed are, in my view, sufficient in their own right. I would say two things about these arguments. First, it is a matter of speculation as to what effect any decision I might make will have on the stability of Equitable Life and of the wider financial services sector. Secondly, with respect to the standing of my Office, while I recognise the strength of feeling that underpins such matters, as Parliamentary Ombudsman my role is to discharge my statutory responsibilities having regard both to the circumstances of each case and to the wider public interest. It would be entirely inappropriate for me to be influenced by current or prospective press comment or indeed by any other form of external 'pressure'. Such factors have had, and will continue to have, no influence on my judgment.

68. I now turn to the arguments put forward for my not conducting a further investigation into the regulation of Equitable Life, as set out in paragraph 58 above.

69. I accept that any further investigation by my Office will have a cost to the public purse. However, administrative justice, like any other kind, has a cost. I will address issues about the costs that will inevitably be

involved when asking Parliament via the Treasury to provide the resources necessary to conduct my investigation.

70. Similarly, I do not find persuasive the argument that I should not conduct a further investigation purely because the matters which would be the subject of that investigation are complex or controversial. Resolving complex and controversial complaints is at the core of the role of all Ombudsmen. I also recognise that any investigation I conduct will take some time. However, that is not in my view a compelling reason for not conducting it.

71. I have already explained in paragraph 66 above why I do not think that alternative remedies exist to which it would have been reasonable to expect complainants to resort to seek redress for any alleged maladministration on the part of prudential regulators or GAD.

72. I am acutely aware that, among the relevant players, I have jurisdiction only over the prudential regulators and, subject to approval of my request for it to be included in my jurisdiction, over GAD. I also would not wish to raise the expectations of complainants that I will inevitably find in their favour - that is only one of a range of possible outcomes.

73. I recognise that it may be more difficult to assess questions of causality and redress, should I find maladministration, without being able to judge the actions of other key players. However, I have already explained that I consider that I should not avoid involvement in issues purely because they are complex. Furthermore, I am not persuaded by these arguments that a worthwhile outcome to a further investigation by me is impossible.

74. The question of whether there may have been regulatory system failure, as has been argued, rather than operational failure is something that I can only determine by conducting a full investigation. In my view such arguments only serve to reinforce the desirability of such an investigation.

75. I recognise that staff and former staff of regulatory bodies will not welcome another inquiry into events at Equitable Life. However, I must balance the interests of individual public servants against the wider public interest and the interests of the hundreds of thousands of people affected by the events at Equitable Life. I will take reasonable steps to mitigate the effects of any further investigation on the staff involved and will have regard to the passage of time since the relevant events took place. While I recognise that time will be required by FSA staff to respond to enquiries from my Office and that this will have resource implications for the FSA, I consider that such implications do not outweigh the public interest arguments underpinning my decision to conduct a further investigation.

76. Finally, I am not persuaded by the argument that, in deciding to conduct a further investigation into the

regulation of Equitable Life, I would somehow be 'opening the floodgates' to many more similar classes of complaint. First, I have no jurisdiction over any of the bodies responsible for financial services regulation after 2 December 2001. Secondly, although I have discretion to investigate complaints put to the referring Member of Parliament more than twelve months after the complainant first had notice of the matters complained about, there need to be compelling reasons for such delay before I will exercise that discretion. It therefore does not strike me as likely in this context that I will receive considerable numbers of complaints about other financial services issues that I could be persuaded to investigate. Even were this to happen, it is not a persuasive argument that I should refrain from undertaking an investigation into one situation because I might be asked to conduct another investigation into other situations. I must treat each complaint on its merits.

77. Furthermore, it is clear to me that Equitable Life is a 'special case' in relation to complaints about regulatory failure - a position recognised by the Treasury when it commissioned the Penrose inquiry to look at these significant and exceptional events. That inquiry, as I have explained, did not address questions of maladministration and redress. My investigation will address these important questions.

### Next steps

78. I have explained why I consider that there is sufficient material before me to indicate that there may have been maladministration and sufficient indications of unremedied injustice to merit a further investigation of the prudential regulation of Equitable Life. I have also considered the arguments about whether such an investigation is in the public interest or is likely to produce a worthwhile outcome. In the light of that, I have decided, subject to agreement that GAD is brought within my jurisdiction, to conduct a further investigation.

79. In conducting that investigation, my aim is to be as transparent and flexible as possible, given the legislative framework within which I work. Although I am required by section 7(2) of the 1967 Act to conduct my investigations in private, I intend that, where possible, all relevant parties will be invited to produce evidence to assist me in the process of establishing the facts. I will consider the degree to which I can publish background information and other evidence in due course and will involve those submitting such evidence in that consideration.

80. In the coming weeks, as indicated above, my staff will write to those individual complainants with issues outstanding from their representations or on their current complaint file. I will also engage in discussions with Government over the extension of my jurisdiction to cover GAD and on the additional resources I will need to support my investigation. I will also invite further representations on the timeframe to be covered by my investigation (paragraph 42).

81. I intend to establish a full, designated team of experienced investigators, supported, where appropriate, by expert actuarial, accounting, legal, regulatory and insurance advisers.

82. I will consult MPs and policyholder action groups on the selection of individual policyholders as lead complainants, representing the principal different classes of Equitable Life policyholder, and will inform all interested parties of the process for conducting the investigation, once it has been determined.

83. I cannot at this stage be specific about how long my investigation will take. While much can be done to prepare for an investigation immediately, the central question of whether GAD will be brought into my jurisdiction will undoubtedly take some time to resolve.

84. However, I hope that this investigation can be conducted within a reasonable timetable, as I am conscious that significant numbers of people - many of them elderly - are in difficult financial circumstances now.

85. To that end, I do not intend to produce a wide-ranging, academic survey of the performance of the broader regulatory system within which Equitable Life sold and managed its policies. My investigation will be focused instead on assessing the validity or otherwise of what I consider to be the key criticisms of the prudential regulators and GAD against the evidence contained in the Penrose papers and in the other evidence submitted to me.

86. This I will do with a view to determining whether maladministration by those bodies caused policyholders and former policyholders of Equitable Life an unremedied injustice.

87. I will keep Parliament informed of progress.

**ANN ABRAHAM**

**PARLIAMENTARY AND HEALTH SERVICE OMBUDSMAN**

**19 JULY 2004**

# Annex A

## Representations received during the consultation exercise

	Letters	Emails	Faxes	TOTAL
MPs	204	5	2	211
Action Groups	3	0	0	3
Policyholders	1,269	291	43	1,603
Government bodies	4	0	0	4
Interested parties	14	0	0	14
<b>TOTAL</b>	<b>1,494</b>	<b>296</b>	<b>45</b>	<b>1,835</b>

### Notes:

1. Multiple responses from individuals have been consolidated and are reflected as a single representation.
2. One joint letter (from Dr Vince Cable MP and Norman Lamb MP) has been counted as two representations. Two members of the public who say they are not policyholders have been included in the policyholder numbers as they both said that their partner is a policyholder.
3. Where letters from individual policyholders have been forwarded by MPs (there were 148 such letters), these have been counted as if they were a direct individual policyholder representation.
4. The three action groups were the Equitable Members' Action Group (EMAG); the Equitable Life Trapped Annuitants (ELTA); and the Equitable Members' Help Group (EMHG). The four government bodies were the Treasury; the Financial Services Authority; the Government Actuary's Department and the Department for Trade and Industry. The 14 interested parties were the Public Administration Select Committee; the Treasury Select Committee; Equitable Life; Lord Penrose; the National Association of Pension Funds; six pension fund trustees; one Peer; the Consumers' Association; and a member of the public.
5. In addition to the above, there were eight referrals of new complaints about Equitable received during the consultation exercise and 44 very late submissions (i.e. received after the end of May 2004). I continue to receive representations.

## Responses from Members of Parliament

A1. I received submissions from 211 Members of Parliament (from a total of 657 non-vacant seats at the relevant time, representing a response rate of 32.12%). 167 asked me to conduct a further investigation; the remainder made no personal submission on the matter.

A2. Of the total received:

- 56 were Labour MPs (from 408 - this reflects a 13.73% response rate)
- 134 were Conservative MPs (from 163 - this reflects a 82.21% response rate)
- 13 were from Liberal Democrat MPs (from 54 - this reflects a 24.07% response rate)
- 8 were from other parties (2 Plaid Cymru, 2 Independent Conservative, 2 Scottish National Party, 1 Ulster Unionist, and 1 Independent - from 34 - this reflects a 23.53% response rate).

A3. Of the 211 letters from MPs received:

- 105 were 'substantive representations' (i.e. put forward the MP's views on whether I should conduct a further investigation and on what basis) - this number is made up of 23 Labour, 67 Conservative, 9 Liberal Democrat and 6

'other' MPs.

- 62 were 'associative representations' (i.e. short letters, associating the MP with the views of another): of these, 60 associated the (Conservative or Independent Conservative) MP with the letter from Andrew Tyrie and 2 Liberal Democrats associated themselves with that from Vincent Cable and Norman Lamb.
- 44 were 'non-substantive representations' (i.e. a letter from the MP covering the submission of constituents' letters while making no personal representation) - 33 of these were Labour, 9 were Conservative and 2 were Liberal Democrat.

## Responses from Policyholders

A4. I received 1,907 representations from 1,603 existing and former individual policyholders. Multiple or follow-up representations have been consolidated and the following figures reflect the number of people making representations not the number of separate submissions, many of which were duplicates while others were follow-ups.

A5. All but four individual responses urged me to conduct a further investigation.

A6. Of these 1,603 individuals:

- 358 were existing complainants whose complaints about Equitable Life had already been referred to me. This was from a total of 591 referred complaints on hand at the beginning of the consultation period, reflecting a response rate from this group of 60.58%.
- 33 were people who had contacted my Office direct about Equitable Life before but who had not had their complaint duly referred to me.
- 12 had had a previous complaint, not related to Equitable Life, dealt with by my Office but who contacted me about Equitable Life for the first time during the consultation exercise.
- 1,192 contacted my Office for the first time during this process.

A7. In addition, I received 8 new referrals from 5 MPs (bringing the total number of referred complaints to 599).

A8. Of the 1,603 individuals making submissions:

- 503 are existing with-profits annuitants.
- 179 have or had Guaranteed Annuity Rate (GAR) policies.
- 201 have or had non-GAR policies.
- 47 are or were members of a company pension scheme associated with Equitable Life.
- 80 have or had made Additional Voluntary Contributions to Equitable Life.
- 485 referred to themselves as 'policyholder' without being specific about the type of policy they have or had.
- insufficient information was provided by 108 individuals to classify them under any of the above groups, although we can infer that they are policyholders from other information provided.

A9. Of the 1,603 consolidated representations received from individual policyholders and former policyholders:

- 191 (11.92%) used the standard template letter produced by Equitable Life Trapped Annuitants.
- 67 (4.18%) used the standard template letter produced by Equitable Members' Help Group.
- 172 (10.73%) used the standard template letter for 'trapped annuitants' produced by EMAG.

- 108 (6.74%) used the standard template letter for 'late joiners' produced by EMAG.
- 110 (6.86%) used the standard template letter for '1990s investor' produced by EMAG.
- 538 (33.56%) made personal (substantive) submissions - of these, 207 were in part based on one of the action group template letters (respectively: 45, 20, 58, 31, 53).
- 417 (26.01%) made very short personal submissions (usually around a paragraph in length, adding their support to calls for an investigation).

**A10.** In total, therefore, 648 template letters, 538 personal, substantive submissions and 417 summary submissions were received. The respective proportions are 40.43%, 33.56% and 26.01%.

**A11.** Respondents came from all regions of the UK:

- 636 (39.68%) were from the South-East of England or from East Anglia
- 226 (14.10%) were from the North-East or North-West of England
- 187 (11.67%) were from the Midlands
- 141 (8.80%) were from the South-West of England
- 126 (7.86%) were from Greater London
- 52 (3.24%) were from Scotland
- 45 (2.81%) were from Wales
- 9 (0.56%) were from Northern Ireland
- 16 (0.99%) were from overseas
- 165 (10.29%) were from people about whom we did not have enough information (primarily those contacting us by email) to be sure of their location.

# Annex B

## Key submissions received

### Excerpts from letters from **Lord Penrose** (22 May and 7 July 2004)

#### EQUITABLE LIFE

As you know, my remit was to enquire into the circumstances leading to the position at Equitable as at 31 August 2001, to identify lessons to be learnt for the future conduct, administration and regulation of life assurance business and to report to Treasury Ministers. That exercise was completed with the delivery of the report, and I have now returned to full time judicial duties. My team has been disbanded and I do not have any continuing support in relation to the affairs of Equitable Life. That appears to me to be right and proper. It was not envisaged that I should have a continuing remit in this matter and finality had to be achieved with the delivery of the report.

Quite apart from the practical implications that arise, however, the report had to express my final views on the matters I was asked to investigate. It would be inappropriate for me to seek to enlarge on the contents of the report, or to engage in any discussions that could detract from, or be thought to detract from, the views I have expressed. The implications of the report remain a matter of controversy, as appears from continuing comment in the press, at the Society's general meetings, and in political circles. As a serving judge I cannot make a contribution to the continuing debate, and I have no wish to do so.

It appears to me to be equally clear that I should have no part in your consideration whether to conduct a further investigation. In carrying out your function you will, I think inevitably, have access to different evidence from the evidence I had available, and the issues you will have to consider, within the terms of your remit, will, equally inevitably, be different from those that engaged my attention as reporter. It would have been, and remains, outside the scope of my remit as reporter to form and express views on the issues you have to consider. It would certainly be inappropriate for me as judge to form and express views that might become the subject of challenge in judicial review proceedings brought against you...

... Policyholders cannot, of course, be expected to understand, as you and I must, the constitutional conventions derived from the separation of powers that preclude a serving judge from involvement in Parliamentary processes such as you conduct. No one with the authority to do so has yet suggested that I should demit judicial office in order to take some further part in this affair! Nor has it been suggested that there is any appropriate role that I could have in an independent judicial capacity...

... I appreciate that all of this might seem unhelpful and, indeed, obstructive. In some respects that may be the result, but it is not the objective, of the decision I have taken. I have an interest in protecting the integrity of my own work, such as it is, and in the final analysis I must approach the issues raised with that in mind. I regret that I do not think it appropriate to meet you to discuss my report in the light of the exercise on which you have embarked.

### Letter from the **Chairman of the Public Administration Select Committee** (26 May 2004)

#### EQUITABLE LIFE

Thank you for your letter of 22 April inviting the Committee's views on whether you should carry out a further investigation into the regulation of Equitable Life and if so in respect of which period and matters. You said in evidence to the Committee that you would consider whether to carry out any further investigation once Penrose had reported and we welcome the extensive consultation you are currently undertaking.

Lord Penrose concluded that the main thrust of his criticism was, "that for the most part it was the system that failed to provide the regulation that changing circumstances in the industry required, not that there was failure to implement what was fundamentally a satisfactory system" (Chapter 20, para 69). Nonetheless he prefaced that conclusion by stating that in the report he had been "critical of the regulatory system, and on occasion critical of the performance of the regulators and their advisers". Moreover his eleventh key finding was that, "There was a general failure on the part of the regulators and GAD to follow up issues that arose in the course of their regulation of the Society, and to mount effective challenge of the management" (Chapter 19, para 240). This suggests there is a prima facie case for investigating potential maladministration.

Therefore it seems to us that:

Firstly you should now carry out a further investigation. The investigation should encompass the same period covered by the Penrose report. The scope of that investigation should also be as wide as possible in terms of the bodies to be examined.

Secondly you should begin by setting out the limits of your jurisdiction as you understand them to be. In your evidence to us on 27 November we discussed some of the difficulties surrounding your ability to pursue maladministration leading to injustice and possible redress in a context where both some of the bodies and conduct of business regulation were not under your jurisdiction. We assume your limitation primarily involves the Government Actuaries Department (GAD).

Thirdly and consequently you should also set out clearly what extension to your jurisdiction you would need to ensure that you are not hampered needlessly by jurisdictional issues. The Committee, as no doubt others in the House, would support your approach to Ministers to ensure speedy passage of the necessary secondary legislation amending Schedule II of the Act as appropriate.

Fourthly when embarking on your investigation you should also make clear a) the criteria under which you are required to undertake your investigations and b) the extent to which, subject to any findings of maladministration and injustice, you are able to recommend redress and the nature of that redress.

Fifth you reminded us in your evidence of 27 November about the difficulties you and your predecessor faced in looking at all the events and all parties involved and why Sir Michael Buckley advocated a full inquiry covering all the issues. In light of this it is important that your further investigation should be undertaken with the cooperation and assistance of Lord Penrose who has had the benefit of a comprehensive inquiry.

Lastly when you last came before the Committee your ability to give evidence with regard to Equitable Life was circumscribed by the judicial review hearing. Now that you are consulting on the way forward on Equitable Life, I am extending an invitation to you to discuss with us how you plan to take this forward, more broadly, how these sorts of inquiry should be conducted in future and the implications this may have for your Office.

**Tony Wright MP**  
Chairman

## Letter from the Chairman of the **Treasury Select Committee** (7 May 2004)

EQUITABLE LIFE

Thank you for your letter of 22 April, asking for any Committee views on possible further investigation by you into the regulation of Equitable Life.

As you know, following the publication of the Penrose Report, the Committee took evidence on Tuesday 16 March from Lord Penrose and from Ruth Kelly. This added to the information in the public domain. However, apart from observations on the general lessons for the development of the long-term savings industry which will be discussed in our planned report on that subject, we have no current plans to prepare a report or do further work on Equitable as such.

Members of the Committee will have their own views on the way forward from here, and will have received your letter to each individual Member of the House. In these circumstances I think it would be appropriate for me to leave it to each Member of the Committee to respond to you individually.

**John McFall MP**  
Chairman

## Letter from **Andrew Tyrie MP** on behalf of the Official Opposition (29 April 2004)

Thank you for your letter of 22nd April inviting representations from MPs on "whether and, if so, in respect of which period and matters, I should carry out any further investigation into the regulation of Equitable Life."

Your letter was timely, and very welcome in view of the publication of Lord Penrose's Report, on 8th March.



The regulatory failure identified by Lord Penrose is particularly well suited to an investigation by the Ombudsman for maladministration. The high regard in which your office is held depends on thorough investigation of such cases.

In summary, I consider that

- you should conduct a further investigation;
- the purpose of your investigation should be to investigate whether any public bodies concerned with the regulation of Equitable Life were guilty of maladministration;
- where any maladministration is found and where, as a consequence, losses have been sustained by policy-holders and annuitants, you should make recommendations for remedy;
- the period covered by your investigation should be the same as that covered by Lord Penrose's report;
- you should invite Lord Penrose to assist you in the investigation;
- you should reconsider your earlier decision not to investigate the Government Actuary's Department (GAD);
- if, after that reconsideration, you still believe such an investigation into the GAD to be beyond your jurisdiction, you should immediately recommend to the government that they request parliament for an extension of your powers of investigation to include the GAD.

Lord Penrose's Report identified regulatory failure both of the system of regulation and of its operation over a sustained period, and particularly throughout the 1990s. These are documented in detail in, among others, Chapters 15 to 18. No doubt you will already be examining Lord Penrose's findings of regulatory failure in the short period covered by your first report, from 1st January 1999 to 8th December 2000. The scale of the regulatory failure identified by Lord Penrose prior to that period, and the accompanying detail he provides, also require investigation. Of the whole period Lord Penrose states: "There was a general failure on the part of the regulators and the GAD"<sup>1</sup>. He writes of 1998, that "GAD's approach over this period seems to me to have been persistently naive."<sup>2</sup> In his conclusions, he describes the Department for Trade and Industry and the Treasury (who were between them responsible for prudential regulation from the early 1980s until 1st January 1999) as "ill-equipped"<sup>3</sup> and the GAD as "complacent".<sup>4</sup> Lord Penrose notes "short-term objectives related to support of solvency that should have alerted regulators to the Society's weakening position."<sup>5</sup> He says that "information was not used to form a realistic appraisal of the society's financial position"<sup>6</sup> and that "unsatisfactory answers were accepted without follow up".<sup>7</sup>

The events described by Lord Penrose which led to these and other conclusions of regulatory failure are very extensive. Among those which would benefit from investigation for maladministration are that public bodies:

- allowed the Society to accumulate huge contingent liabilities by selling unguaranteed policies without ring-fencing the funding of Guaranteed Annuity Rate (GAR) policies and without declaring that those prior guaranteed policies existed;
- failed to discover that the Society was not reserving for the guarantees expressly contained in the GAR policies;
- endorsed the Society's attempt to redress the balance by paying differential bonuses, later ruled illegal;
- permitted the publication of inadequate accounts and the submission of inadequate regulatory returns which obscured the financial weakness of the Society;
- failed to recognise the inadequacy of the reinsurance policy negotiated to cover reversionary bonuses for GARs in late 1998 and early 1999;
- allowed the Society to "over-bonus" for many years;
- allowed the Society to trade with totally inadequate reserves and to claim throughout that they were selling a low-risk product, coupled with prudent management and the benefits of mutuality.

The GAD was the subject of particular criticism by Lord Penrose. In your first report you took the view that the GAD was

outside your jurisdiction and gave your reasons. I strongly urge you to reconsider that view. In evidence to the Public Administration Committee you said you were influenced by the description of the GAD in government documentation "as a separate department rather than subordinate to the Treasury"<sup>8</sup>. However, after taking evidence from the Treasury and the GAD the Treasury Select Committee concluded that the GAD was a "non-Ministerial government department . . . to provide actuarial advice to Ministers"<sup>9</sup> and that it "does not have policy-making responsibilities of its own." I know of no advisory government department, the accountability for which does not flow through a Minister. In this case, responsibility for the GAD clearly lies with the Treasury. The GAD is therefore not independent but subordinate to the Treasury, a department maladministration of which may be subject to investigation by you. You will, in any case, want to consider whether the Department of Trade and Industry and the Treasury asked the right questions of the GAD and acted correctly on the responses.

Should you feel unable to reconsider your earlier conclusion that the GAD was beyond your jurisdiction I strongly urge you to invite the government to obtain parliamentary authority to add the GAD to the list of bodies which you can investigate. This can quickly and easily be done by amending Schedule 2 to the 1967 Act, using a negative Statutory Instrument.

The addition of the GAD to your list of responsibilities will not preclude a retrospective investigation for maladministration. The Parliamentary Commissioner Act 1967 enables you to extend an enquiry beyond the period of 12 months before a complaint was made if the Ombudsman "considers that there are special circumstances which make it proper to do so." (6.3) I consider that the long and detailed investigation of Lord Penrose, and his findings, constitute "special circumstances". Further clarification of Parliament's intentions with respect to retrospection is provided by Clause 14 (3) which states that "a complaint under this Act may be made in respect of matters which arose before the commencement of this Act". This presumably would be expected to apply also to complaints made in respect of matters covered by an extension of the Act's scope. In the House on 24th March the Financial Secretary to the Treasury, Ruth Kelly, dismissed my suggestion that the GAD should be added to your list of responsibilities on the grounds that such retrospection was not permitted. She has recently reversed her view on retrospection in a letter to me, which I attach.

Of course, your view on the period that should be covered by your investigation relates to all the relevant public bodies, not just the GAD. As you pointed out last year, it was a decision of your predecessor to limit the period of investigation to less than two years. I consider that the special circumstances brought about by Lord Penrose's Report warrant an extension of your investigation to include the whole of the period covered by him.

In your earlier report you distinguished between public bodies falling within your jurisdiction when they were acting as the prudential regulator and conduct of business regulation, which falls outside your jurisdiction. Having examined the Penrose Report, I am not persuaded that this should be a substantial bar to your work. A very large proportion of the regulatory failure identified by Lord Penrose was of the prudential kind. Furthermore, prudential regulation and conduct of business regulation was, in certain periods, carried out by the same bodies. For example, from 1st June 1998, the Personal Investment Authority, which had responsibility for conduct of business regulation since 1994, contracted out its role to the FSA. The FSA also became responsible for prudential regulation six months later.

I strongly urge you to invite Lord Penrose to participate as fully as possible in your further investigation for two reasons. First, his lengthy investigation has left him uniquely well placed to assist you. Secondly, his involvement will enable you to conduct your inquiry more quickly, without any loss of thoroughness. Minimising the delay will reduce further uncertainty about the industry created by the Equitable Life affair. Even more important, minimising further delay is essential for those most deeply affected: we are dealing with nearly a million policy-holders and annuitants, a high proportion of whom are elderly and vulnerable. All of us owe it to them to complete this essential work as quickly as possible.

This letter represents the views of the official Opposition and, with that in mind, I would be very grateful for an opportunity to meet you to discuss these issues further.

**Andrew Tyrie**  
Shadow Financial Secretary

<sup>1</sup> Penrose Report, Part VII, Chapter 19, Paragraph 240

<sup>2</sup> Penrose Report, Part VI, Chapter 15, Paragraph 78

<sup>3</sup> Penrose Report, Part VII, Chapter 19, Paragraph 158

<sup>4</sup> Penrose Report, Part VII, Chapter 19, Paragraph 160

<sup>5</sup> Penrose Report, Part VII, Chapter 19, Paragraph 187

<sup>6</sup> Penrose Report, Part VII, Chapter 19, Paragraph 209

<sup>7</sup> Penrose Report, Part VII, Chapter 19, Paragraph 228

<sup>8</sup> Oral evidence to the Public Administration Committee, 27th November 2003

<sup>9</sup> House of Commons Treasury Select Committee, 7th Report, Session 2000-01

## Letter from **Vincent Cable MP and Norman Lamb MP** on behalf of the Liberal Democrats (13 May 2004)

### EQUITABLE LIFE

Thank you for your letter of 22 April. My colleague Norman Lamb and I are writing on behalf of Liberal Democrat MPs responding to your request for representations to be made to you as to whether you should carry out further investigations into the regulation of Equitable Life.

### Early Day Motion 1090

Our view is outlined in the wording of EDM 1090, co-signed by Norman Lamb and myself. This notes that the Penrose Report identified operational regulatory failure as well as failings of the regulatory system. As such it is now appropriate for an assessment to be made as to whether such failure amounts to maladministration.

### Findings of Lord Penrose

When you originally agreed to investigate whether there had been maladministration during the period when the FSA was acting as regulator on behalf of the Treasury, you made it clear that you would wait for the Penrose Report to be published before deciding whether to expand your enquiry to look at the earlier period. Lord Penrose conducted an exhaustive investigation of this period. It seems now to be appropriate for you to determine findings of fault amount to maladministration.

As I noted in my response to Ruth Kelly when Lord Penrose's report was laid before the house on the 8th March 2004 there are several areas which Lord Penrose identified as regulatory failures which went beyond systemic failure. Those I mentioned were:

- The DTI's appointed actuary also being Chief Executive of Equitable in the period between 1991-1997 Penrose, section 240 (7)
- The government in its regulation did not take into account that a number of measures used to finance the Society's solvency position were predicated on the emergence of a future surplus: section 240 (10)
- A wider failure by the GAD to follow up any issues that arose in the course of their regulation and to mount effective challenge of the management, section 240 (11)

The crucial question is whether these criticisms by Lord Penrose amount to maladministration. It is not for Members of Parliament to make that judgement. This is properly a matter for you to investigate. This is not without precedent. The Parliamentary Ombudsman's follow up to the Le Quesne report into Barlow Clowes in 1988/1989 followed this course of action.

### Lord Penrose's remit

Crucially, Lord Penrose was not asked and nor did he look at whether there was a case to answer over maladministration. He made this clear in his report and when later questioned by the Treasury Select Committee:

**Q631 Norman Lamb:** ... Lord Penrose. I fully understand the "gates" you say you have to go through in order to establish a link between failure and loss that might result from it; but saying you cannot infer one from the other crucially is not the same that you do not rule it out. It is simply not part of your remit?

**Lord Penrose:** That is so

**Q632 Norman Lamb:** So you cannot rule out the possibility that compensation does flow from failures of the regulatory system?

**Lord Penrose:** I have sought to avoid adjudicating one way or the other.

*Examination of Witnesses (Questions 620-639, 16th March 2004)*

The issue of maladministration is particularly relevant to the Government Actuaries Department. I appreciate that the GAD is not currently within your remit and thus you cannot investigate any case of potential maladministration within the GAD. However after cross party pressure Ruth Kelly has conceded that the GAD could be added to the list of bodies you can

investigate. Ruth Kelly has since written to confirm that she would consider extending your remit following a request from yourself.

Can I therefore urge you to request from Ruth Kelly that the Government Actuaries Department be added to the list of bodies you can investigate. Following that can I ask that you reopen your enquiries into maladministration in the case of Equitable Life more broadly?

**Vincent Cable MP**  
Lib Dem Shadow Chancellor

**Norman Lamb MP**  
Treasury Select Committee member

## Letter from the Equitable Members' Action Group (EMAG) (18 May 2004)

In advance of our meeting next week I enclose EMAG's response to your consultation request.

We understand that the Government has indicated that it would accede to a request from you to extend your jurisdiction retrospectively to the Government Actuary's Department. We believe that any further investigation by you would be meaningless without such jurisdiction and recommend that you request such powers.

In Chapter 20 Lord Penrose says:

*64. One of the regulators involved with Equitable referred to the boundary between prudential and conduct of business regulation as more an awkwardness than a lacuna. While that may be a fair comment on how the two branches were intended to operate, in practice the lack of co-ordination of prudential and conduct of business regulation in relation to the Society was unacceptable. The Society's changes of policy forms and of the guarantees provided is a typical area where there was a role for each regulator. The conduct of business team were no doubt interested to ensure that the prospectus met the requirements of the disclosure. There may be questions whether the risks were adequately focused in the Society's literature in any event. But the risks could not have been assessed by the conduct of business regulator without reference to the prudential regulator. Had this happened, it might have focused attention on the implications of the low free asset ratio for new policyholders.*

In the light of his comments, you might usefully consider whether your jurisdiction could be extended to cover the relevant 'conduct of business' regulator.

**Colin Slater**  
Deputy Chairman

EMAG's Criticism of the Parliamentary Ombudsman's first report on Equitable Life. Updated in the light of Lord Penrose's report.

### PART I - POINTS OF PRINCIPLE DISCLOSED BY LORD PENROSE

The original report of the Parliamentary Ombudsman Ann Abraham ('PO') covered only the period from 1st January 1999 to 8th December 2000. It considered only one 'representative' investor, Stewart Simpson ('Mr P'), who bought a with-profit annuity in June 2000, just before the House of Lords decided against Equitable Life's differential terminal bonus policy in the Hyman case.

#### Limitations of Time and Scope

Penrose makes it clear that the real failure of regulation occurred during the period 1987- 1998. The PO restricted her investigation to the period of the FSA's involvement 1999-2000. The critical period was not covered.

The PO claims that the Government Actuary's Department ('GAD') is outside her jurisdiction. It is accepted that it is not on the 'list' contained in the Parliamentary Commissioner Act. However that Act does give her to jurisdiction over 'unlisted' departments acting 'on behalf of' listed ones. This is how she investigated the FSA, which is also 'unlisted'. Her theory is that GAD acted only as advisers, whilst the empowered regulator (Department of Trade and Industry 'DTI' to 1997, Treasury 1998-2000) carried the responsibility. Penrose reports that in practice the DTI was incapable of fulfilling its functions and 'for all practical purposes, scrutiny of the actuarial functioning of life offices was in the hands of GAD until the reorganisation under FSA was in place [in 2001].' In short GAD did most of the job. Why should policyholders be

denied access to justice because a part of a listed department's (DTI) functions were subcontracted to an unlisted one (GAD)?

### Key New Evidence (a)

Each year the Society's actuaries were required to present a 'solvency' return to the regulators comparing, on the one hand, its contractual liabilities (excluding terminal bonuses) to policyholders with, on the other hand, its assets. This was a lengthy and technical appraisal and was studied by the regulators. Lord Penrose shows that, in presenting these returns, the Society's actuaries consistently used the least prudent methods of valuation and indulged in several practices of 'dubious actuarial merit'. These included:-

- 1) valuing future liabilities at an inappropriate rate of interest. This typically understated those liabilities in the period 1990-1996 by about £500 million
- 2) treating selling costs as an asset, estimated in 2000 at £900 million
- 3) making no provision for the guaranteed annuity rate ('GAR') cost applicable to the (undisputed) contractual liabilities until much too late
- 4) valuing a financial re-insurance policy, which proved to be worthless, at over £800 million in the years 1998-2000
- 5) placing increasing reliance on 'future profits' allowances (from £250 million in 1994 to £1,000 million in 2000)
- 6) taking on a 'subordinated loan' of £346 million in 1997 which was not counted as a liability

Lord Penrose revises the solvency figures eliminating items 4-6. For no explained reason, he makes no adjustment for items 1-3. Had he done so, Equitable Life would appear to have been technically insolvent for the whole decade of the 1990s.

Lord Penrose makes it clear that the regulators lacked confidence, consistency and robustness in countering these devices. Only the re-insurance policy was considered in detail by the PO's report.

### Key New Evidence (b)

Lord Penrose attributes part of Equitable Life's demise to its persistent practice of voting bonuses well in excess of assets (over-bonusing). He chronicles the movement of the realistic financial position shown by the 'office valuation', which compared the aggregate of policy values indicated to members (including terminal bonuses) with the value of assets available to support it. It discloses a deficiency of assets ('un-funded policy value position') from 1989 onwards.

Year	Assets £ million	Aggregate Policy Values £ million	Unfunded Policyvalue Position £ million	Unfunded as a % of Assets
1989	4,921	5,166	(245)	-5%
1990	4,902	6,277	(1,375)	-28%
1991	6,266	7,805	(1,539)	-25%
1992	7,915	9,214	(1,299)	-16%
1993	10,880	11,065	(185)	-2%
1994	10,817	12,956	(2,139)	-20%
1995	13,366	14,962	(1,596)	-12%
1996	15,699	17,424	(1,725)	-11%
1997	19,240	20,598	(1,358)	-7%
1998	21,367	23,567	(2,200)	-10%
1999	26,139	26,873	(734)	-3%
2000	25,843	28,900	(3,057)	-12%

The above figures include a substantial allowance for GAR costs only in 2000. The office valuation confirms the validity of the conclusions reached in the report that EMAG commissioned from Chartered Accountants Burgess Hodgson, which was published in March 2003.

The table demonstrates that Equitable Life's 'smoothing kitty' was overdrawn throughout the 1990s culminating in an

'overdraft' of £3,057m at 31st Dec 2000. Lord Penrose estimates that about £1,800m of this related to excess bonuses paid out to departing policyholders during that decade. Equitable Life was running a Ponzi-type scheme.

Lord Penrose shows that by June 2001 the asset deficit from all sources had grown to £4 bn and he says that over-bonusing was a 'major contributory factor to the weakness that required a substantial reduction in policy values in July 2001' (Chapter 19 Paragraph 56). He confirms that this cut applied to with profit annuitants as well as to pension and endowment investors. Because the cut related to policy values rather than bonuses, late joiners such as Mr P were particularly hard hit. They had enjoyed little or no benefit from past excess bonuses, but their policy values (effectively the amounts they had invested) were cut anyway.

The PO's report did not sufficiently consider this aspect of the Society's finances.

Lord Penrose described the smoothing of a with profit fund as follows (Paragraph 62 Chapter 19):-

*'Smoothing is generally taken to imply that payout ratios should average 100% of a projected norm over time, with aggregate policy values and payouts running below the level of available assets during market peaks, and above the level during downturns. A rigorous and prudent adherence to a clearly defined set of smoothing parameters would appear to be all the more essential in a fund that is being operated on the basis of a policy of full distribution and no estate [as Equitable Life operated].'*

In short, the existence of deficits in years when the stock market was low (e.g. 1990 and 1994) might have been acceptable if there were surpluses in years when it was high (e.g. 1993 and 1996-1999).

Lord Penrose says 'In and after 1989, when the Society adopted a new approach to accumulating policy values, the failure to recognise accruing final bonus in its entirety was untenable, having regard to the terms of the statute and to the Society's publications and communications with policyholders.' (Chapter 19 Paragraph 75)

Representations were apparently made to him by the Society itself, by GAD, by the Treasury and by the FSA that the pattern of values shown above constituted an appropriate smoothing policy. Lord Penrose rejects this approach.

'Apart from the absence of a consistently expressed and coherently followed smoothing policy (of which more below), it is hard to reconcile what the inquiry has found with any credible approach to smoothing. The Society's pattern of 'smoothing across the peaks' (to borrow Headdon's phrase) did not represent, and *could not have represented*, a credible approach to smoothing for a mutual espousing the principles the Society did.' (Chapter 19 Paragraph 240, emphasis added).

The Treasury, on advice, has now, as we believe rightly, accepted the correctness of Lord Penrose's view. The PO's report accepted the now discredited Equitable/GAD/FSA line.

### Incorrect interpretation of Regulator's Responsibilities and Powers

In addition to maintaining technical solvency, the 1982 Insurance Companies Act requires the regulator to assess whether the long-term insurer can meet policyholders reasonable expectations ('PRE'). Unlike most with-profit companies Equitable Life created its own quite specific PRE by sending members annual policy valuations. These were not 'funny money' estimates of prospective future entitlements, but were current values, upon which actual payments to departing policyholders were based.

Lord Penrose says that the regulator (DTI) asked for and received the responsibility to police and the powers to enforce Policyholders Reasonable Expectations in respect of the maintenance of a smoothing fund. His report demonstrates that the policing was badly done and the enforcement powers were not used:-

*'The regulators acted as if they had power to investigate PRE with a view to taking action, and I believe that they were right to do so. They never got round to taking such action, but that is a different matter.'*  
(Chapter 15 paragraph 18)

The PO largely ignored PRE and the responsibilities placed upon the DTI and (later) the Treasury by the Insurance Companies Act and regulations issued under it. In particular, she made no attempt to consider the effect of a part of all new investment being used to make excessive payments to departing policyholders. She accepted the regulators' excuse that the concept of 'light touch' prevented them identifying the problem and taking action, notwithstanding the draconian powers available to them under the Act.

Penrose stresses the regulators' statutory responsibilities and barely mentions the 'light touch' concept. The principle, as

we understand it, rejects heavy additional reporting requirements, but expects the regulator to act where he picks up PRE issues from the solvency returns. If he does so, the Insurance Companies Act 1982 gives the regulator wide powers to protect PRE. Lord Penrose reports that the PRE numbers (the office valuation) were actually supplied to the regulator from 1991 onwards. The figures (reproduced in the above table) consistently showed a deficit of asset values as compared to the aggregate of policy values represented to members. Lord Penrose's report shows that the regulators took *no effective action* to protect PRE in the form of Equitable Life's promise of a 'smoothed asset share'.

## PART II - SPECIFIC MATTERS

In addition, Lord Penrose takes a more rigorous view of some of the regulatory actions 'cleared' by the PO.

### The FSA's Gross Error of Judgement and Administrative Failure

The main complaint against the FSA during the limited period covered by the PO's Report was the undue reliance that it placed upon the Society's market value. Equitable Life was allowed to continue to trade and advertise aggressively after it lost in the Court of Appeal (January 2000) and even after it lost in the House of Lords (July 2000) on the assumption of a substantial market value (£3 to £5 billion). In the event no one was prepared to pay anything at all for Equitable Life's goodwill.

Bidders were surprised by the poor state of the Society's finances and by the risks inherent in the fund. They concluded that the cost of making good the asset deficit was greater than the goodwill of the world's oldest life insurer running a £30 billion fund. They came to that conclusion in a matter of weeks.

Lord Penrose report shows that the FSA and its predecessors had known for almost a decade that the Society had a deficiency of assets, which any purchaser would need to make good out of whatever amount he was prepared to pay for the business. Nevertheless the FSA with little thought or calculation, managed to assume that Equitable Life's goodwill carried a substantial value. The FSA were wrong to the tune of several thousand million pounds.

Lord Penrose says:

*'...it remains my view that the regulators' inability to make an independent and reliable assessment of the Society's financial position from information gathered through the regulatory process at this critical stage was a serious impediment, and is a further indication that there are serious issues about the effectiveness of regulation generally at that time.'* (Chapter 18 Paragraph 63)

This valuation was crucial to Mr P's case, since the FSA deliberately sacrificed his and many other 'late joiners' interests so as to safeguard existing policyholders' rights to this goodwill.

Of the absence of a 'Plan B' Lord Penrose says:-

*'The question that regulators and GAD failed properly to address was not whether the actual result [of the Hyman case - July 2000] should reasonably have been anticipated, but whether the outcome was within the range of possible results for which contingency planning should have been in place so as to instruct their enquiries and supervision over the material period. As discussed above, the possibility of failure was included in the list of scenarios, but that did not lead to significant planning for the event.'* (Chapter 18 Paragraph 66)

Of the failure of the FSA to protect the interests of 'late-joiners' Lord Penrose expressed concern.

*'It appears that the regulators proceeded on an assumption that, if anyone were disadvantaged by the decision, compensation would be available. No legal assurance was sought that this would be so, and there was no examination of the legal issues involved. There was no recognition recorded that, if compensation claims were sustained, those claims would be at the expense of the with-profits fund, nor any attempt to quantify the risks to which potential policyholders were exposed relative to the benefit claimed by management for continuing to trade. No consideration was given to measures that might have mitigated the potential for subsequent claims of misrepresentation. The Society was even permitted to continue its advertising, and so those taking new or further policies with the Society did so by invitation and not as mere volunteers, without the risks of doing so being made known to them.'* (Chapter 18 Paragraph 115).

He goes on to suggest an obvious but unconsidered alternative. 'But there might have been contractual options open in the

case of new contracts at least that would have allowed for penalty-free transfer of funds to another provider, for example, in the event of failure of the sale: that could have been seen as an appropriate counterpart of the proposal to exclude such policyholders from the benefit of the proceeds of sale. Other possibilities could no doubt have been developed. To allow business to continue without exploring means of protecting those who were exposed to risk by the decision, and relying on an untested view that there would be a remedy was unfortunate.' (Chapter 18 Paragraph 116)

In short, Lord Penrose exposes the regulators' failure to discharge their responsibilities to investors in 2000, in a way not appreciated by the PO, who had less knowledge of Equitable Life's history and practices and less detailed understanding of the regulators' duties and powers.

### The Re-Insurance Policy

During 1999 the Society bolstered its technical solvency position by taking out a re-insurance policy with Irish European Reinsurance Company Limited. The contract was at best an agreement to refinance GAR costs and at worst a sham.

Lord Penrose found it 'difficult, if not impossible' to bring the refinancing arrangement with Irish European Reinsurance Company Limited within the scope of the regulations. He said 'Treating the contingent rights of the Society as a present asset appears to involve a very strained construction of the regulation' (Paragraph 105 Chapter 7). Even if it were allowed, he found the sums ascribed to it [over £800m] were 'disproportionate to the benefit understood by the Society and regulators to be conferred by the treaty.' The regulators bent over backwards to facilitate this arrangement, giving credit in the 1998 return, even though the agreement was not signed until September 1999. They also knew that Irish European was taking no real risk. Other re-insurers had suggested very much higher premiums for policies that did take on real risk.

The PO considered that episode and cleared the FSA of mal-administration. In the light of Lord Penrose's analysis we believe she was wrong to do so.

In addition to points upon which Lord Penrose sheds more light, EMAG found other unsatisfactory aspects of the PO's report including factual errors, which we have been able to identify from our own knowledge.

### Errors in taking evidence leading to factual mistakes

In exercising the quasi-judicial role of Parliamentary Ombudsman Ms Abraham erred in taking extensive evidence from those complained about, but *NONE AT ALL* from the complainants or anyone else who might have contributed some degree of balance to the process.

The PO clearly but mistakenly believed that Mr P (the complainant) was able to transfer his investment in Equitable Life elsewhere. He is not so able; with-profit annuitants are locked in. This is a simple but crucial error of FACT. She also criticised Mr P for not taking professional advice, which was also incorrect in fact. The PO did not check either matter with Mr P. She did not interview him at all before publishing her report.

The report describes a meeting of an ELAS spokesman (Alistair Dunbar) with members of the Equitable Members Action Group (EMAG) in 2000. Notes taken at the time and then published on the EMAG web-site record doubt as to ELAS ability to meet its solvency requirements. At least one of those present (Tom Lake) is a continuing EMAG committee member.

The PO discounted that evidence, by quoting the response of the Society's current lawyers, who were NOT appointed at that time and were NOT present at the meeting. She took no steps to verify the position with Tom Lake or indeed anyone who had been present at the meeting (including apparently Mr Dunbar, who still works for Equitable Life).

## PART III - SUMMARY OF CRITICISMS

### Points of Principle

Lord Penrose's report undermines the basis of the PO's report in the following fundamental ways:

- 1) The PO's report did not consider the over-bonusing, which was a contributory factor in the Society's demise and in the losses sustained by those who held policies on 16th July 2001 and thus suffered the policy value cuts.
- 2) The PO's report did not consider the question of PRE in the context of the relationship between policy values and assets. To the extent that she knew about the asset deficit, she accepted the Equitable Life/GAD/FSA line that it was part of its smoothing policy. Penrose conclusively discredits this approach.
- 3) The PO's report accepted the regulators line that the 'light touch' approach required them to consider only 'technical



solvency' (which ignored terminal bonuses) and virtually to ignore PRE in the context of balancing total policy values (including terminal bonuses) against assets. Lord Penrose found that the regulators had the responsibility and the powers to police PRE, but shows that they were ineffective.

4) The PO's report examined only some of the practices of dubious actuarial merit by which the Society maintained its technical solvency.

5) The PO's report covers a short period, long after the real damage was done

6) The PO's report claims to lack jurisdiction over the GAD, whose actions (and in-actions) were criticised by Lord Penrose. His descriptions of the manner, in which GAD worked, supports the view that it carried out part of the regulatory functions of the DTI, which was ill-equipped for the role. In our view this brings GAD within the jurisdiction of the PO.

### Specific Matters

Lord Penrose correctly identified the regulatory failures, which were insufficiently considered by the PO.

1) The regulators failed to use the information and powers at their disposal to make a reasonable assessment of how much of the total amount a purchaser might pay for the Society's business would be consumed by the need to make good the asset deficit. Given the previous history of misconduct of the Society's affairs, of which the regulators had notice, they should have been extremely dubious about accepting the director's assurances that the Society's business could be sold. In fact they assumed those assurances were well formed and sacrificed the interests of 'late-joiners' to protect a goodwill value that proved to be illusory.

2) The regulators considered no 'Plan B' in the event that a sale could not be achieved.

3) The regulators failed to insist upon even the simplest steps to be taken to protect late joiners, instead relying upon untested legal remedies.

4) The regulators accepted a high value for the re-insurance agreement, whereas in fact it was effectively worthless.

In addition:

5) In EMAG's view, the PO's original report was unbalanced in taking evidence, which led to both factual errors and undue influence from those being investigated

In the light of the factors shown in Lord Penrose's report the PO's earlier report was clearly prepared upon unsuitable assumptions, did not investigate the actions and in-actions of regulators with appropriate rigour, was biased in taking evidence and should be withdrawn.

### PART IV QUESTIONS RAISED BY LORD PENROSE'S REPORT

Lord Penrose was not instructed to apportion blame. However his report provides ample evidence for policyholders to form their own views. Obviously the main fault lies with the old directors. However they could not have perpetrated their activities for as long as they did and get the Society into a state of terminal decline, without a regulatory system that was badly organised, lacking in rigour and self-confidence and *almost totally ineffectual*. Policyholders have a right to be outraged that a major insurer was so badly regulated. They are also entitled to ask the Parliamentary Ombudsman to investigate aspects of this fiasco for mal-administration. Examples include:

a) Regulators did not identify that guaranteed annuity rates would become a problem as interest rates fell during the 1980s, even though it was inherent in the deferred annuity contract that was widely used by the industry for pension provision from the mid 1950s until the late 1980s. By the time the matter was belatedly examined by the actuarial bodies in 1997 it was estimated that policies worth £35 billion were involved. Why not? Whose job was it? Why was it not done?

b) In 1989 Equitable Life actuary executives Roy Ranson and Chris Headdon published 'With Profits Without Mystery'. This was a technical statement for the actuarial profession of how Equitable Life was run. It disclosed that Equitable operated without an 'estate' of surplus assets that helped other companies finance expansion and provided security for the inevitable 'rainy days'. It also set out the Society's intention to distribute profits fully as they arose. This should have put regulators on their guard that Equitable was taking unusual risks, but there is no indication that it did. Why not?

c) The amazing fact revealed by Lord Penrose is that the awful state of the Society's affairs in 1990 (assets fell short of values indicated to policyholders by 28%) was reported to GAD in 1991. This should surely have initiated closer inspection of Equitable Life's finances, which might have revealed its substantial guaranteed annuity rate problem and the practices of dubious actuarial merit that it used to bolster its technical solvency. Why was no such inspection undertaken?

d) Roy Ranson appears to have supplied GAD with the 1990 figures in the expectation that the department would take no action, would be 'implicated' in the Society's wrongdoing and consequently allow him plenty of time to turn things around. His poor opinion of GAD was justified by events. How was this allowed to happen?

e) Lord Penrose further reveals that the 'office valuation' figures for later years were supplied to GAD from time to time and both could and should have been required every year. Yet as individual scrutinising actuaries changed the matter seems to have been 'forgotten'. For example, it was not used to illuminate annual decisions on 'future profit' allowances. Why not?

f) The weakness of the Society's finances was not communicated to the conduct of business regulators, who may well have taken action upon the clear conflict between Equitable Life's 'safe and prudent' projection of its activities and the facts of its finances. How many policyholders would have started/continued to invest in the Society if they had known that their terminal bonuses were only partly covered by assets even at stock market peaks and that the Society's much vaunted past performance was largely hot air? Why were conduct of business regulators not informed?

g) Lord Penrose reveals that even the solvency numbers, which GAD studied in detail, were riddled with imprudent assumptions and practices of dubious actuarial merit. Why were none of these found and acted upon?

h) Bidders for Equitable Life were surprised by the poor state of its finances and by the practices that the regulators had allowed it use. They were clearly concerned that if they acquired the business the regulators would require them to inject money to fill the holes. Did regulators adopt a different (much lower) standard for Equitable Life than they applied to the rest of the industry? If so, why?

i) The Burgess Hodgson report showed that the non-profit (conventional annuity) side of the Society's business was a drain on its finances during the 1990s. Lord Penrose report effectively confirms that this was the case, but does not say so explicitly. Was this aspect being run at a loss? Should regulators have identified it? This is important, because any loss was being borne by the with profit investors. Furthermore the Society repeatedly included in its investment performance claims, growth which supported the non-profit side, which was not available to with-profit investors and which exaggerated the apparently healthy margin between growth and distribution. The Society's presentation was misleading. Should not the regulators have identified this? Should they not have insisted in changes of presentation?

j) The DTI allowed Roy Ranson to hold the conflicting roles of both Appointed Actuary and Chief Executive during the critical early years of the 1990s. This was clearly against their considered judgement. It must have been apparent from 'site visits' that Ranson dominated Equitable Life at this time. Why did they allow it?

k) It is known that in addition to its regulatory functions GAD also advised other public service departments upon pension matters. For example civil servants, MPs, judges and health workers all had policies with Equitable Life. Did this conflict of interest affect the way the Society was regulated?

Finally, Lord Penrose has identified relevant issues that were not properly considered in Parliamentary Ombudsman's first report.

l) The Treasury demanded that full provision for GAR costs be made in the 1998 solvency return. To have done so would have rendered Equitable virtually insolvent. When threatened with judicial review the Treasury backed down. Why?

m) Lord Penrose concluded 'In the case of the reinsurance agreement, it is not clear on what basis the Society was permitted to take the credit against its potential annuity guarantee liability that it did [£800+ million].' Why was that credit allowed? How was the amount justified?

n) Lord Penrose reports that in spite of the information gathered over many years the regulators were not able to make a reliable assessment of the Society's financial position to assess the prospects of a sale in 2000. As a result the FSA failed to protect the interests of 'late joiners' such as Mr P. Why was this? Why was there no 'Plan B'?

## PART V CONCLUSION

There is ample evidence that the PO's first report looked at the wrong period and the wrong people and was based on a wrong interpretation of the regulators' duties and powers. It should be withdrawn forthwith and a new one prepared to address the questions raised above.

### Letter from the Chairman of **Equitable Life Trapped Annuitants (ELTA)** (1 May 2004)

Ms Ann Abraham, the Parliamentary Commissioner has written to me asking for some input regarding a further investigation by her office into the regulation of the above company. My response falls into two parts:

#### A) In my capacity as the Chairman of ELTA

As you may know, I have set up and manage a group called ELTA (Equitable Life Trapped Annuitants) that is seeking compensation through the courts for the actions of Equitable Life. To that extent, I have access to a large database of information about the members annuities and how they have been affected by the debacle surrounding this society and the failure of the relevant Government departments to conduct their affairs in a manner that the public have a reasonable right to demand from the Civil Service.

Self evidently, that information cannot be disclosed to you with out the consent of the individual member, though I am at liberty to provide you with statistical data should that be of value.

I am also able to ask members if they are prepared to put their names forward as being willing to provide their personal data, history and experiences to you should you decide that a wider survey of members and their experiences of dealing with the various Government departments would enhance the input and thus hopefully the output from your investigation.

Finally may I request that you look at the ELTA web site [www.elta.org.uk](http://www.elta.org.uk) review its contents particularly the various reports that can be found there that highlight the many failures of all the parties involved in this saga and not least a number of Government departments.

#### B) In my capacity as an Annuitant of the Society

I consider that the issues you should include in your further investigation are as follows:

- a) Lord Penrose shows that Equitable's difficulties began long before 1st January 1999 at a time when the DTI was responsible for prudential regulation and thus your investigation needs to go back well before the GARs were withdrawn by the Society in 1988 and before the Society introduced the With-Profits Annuity.
- b) Lord Penrose makes it clear that the GAD was acting as agent for the DTI. The work of the GAD is therefore the work of the DTI, which is a body within the scope of the Parliamentary Ombudsman's activities. This should specifically focus on why the GAD failed to act after the presentation of the With-Profits Without Mystery (WPWM) paper by Mt Headdon to the Institute of Actuaries, which was widely condemned by members at the time.
- c) Lord Penrose showed that Equitable had no genuine smoothing policy as it pretended, and that it was essential to prudent management. Specifically, why the regulators allowed the Society to make such assertions, when the WPWM presentation specifically stated that the Society did not intend to keep any reserves.
- d) The new inquiry must be extended back at least from the time that the Equitable's estate began to be dispersed, which is 1973. 1973 is also an important date in that it was when PRE was first given official recognition in the Insurance Companies Act of that year. This the year when Mr Sherlock and Mr Ranson took over from Maurice Ogborn, and the pivotal year when the Society decided to persist with its new sales drive to replace FSSU business in spite of swinging capital losses - as a result of which reversionary bonus levels were maintained. It's also the year in which there was a switch to non-guaranteed bonuses which didn't need to be reserved for. In essence, therefore, it was the year in which the road to selective discrimination against newer policyholders, non-disclosure and misrepresentation began.
- e) The new inquiry must include the actions or inactions of these Government departments on whom the public rely to use their expertise to protect them, the public, from errors of omission or commission that lie outside their own reasonable experience.

f) The new enquiry must invite contributions from the various user associations that have been formed to protest at the action of the Society, such as ELTA, EMAG and others.

g) The new enquiry must invite contributions from a reasonable wide selection of individuals who are With-Profits Annuitants of the Society and whose experience of dealing with the Society itself and various Government departments will contribute to a greater understanding of the problems that have been created.

h) The new enquiry must invite contributions from those members of public or professional organisations that have written extensively on the Equitable Life saga and whose insights and conclusions will contribute a greater understanding of how and why the events that have occurred were actually caused.

i) When the inquiry is reopened, it must be conducted in a fair manner, which does not invite the legal challenge, which the first Report has naturally attracted. This will require procedure in accordance with natural justice, which was not perceived to have been the case with the first inquiry.

I hope you find these comments useful and if I can be of any further assistance please do not hesitate to contact me by phone or email.

**Peter Scawen**

## Letter from the **Equitable Life Members' Help Group (EMHG)** (12 May 2004)

Regarding the Parliamentary Ombudsman's request for representations on the subject or the Equitable Life situation, I should like to put forward the following representation.

The Penrose Report that was issued to the public in March 2004 points at several possibilities of regulatory failure over the period in which Lord Penrose investigated. I feel that Lord Penrose's findings deserve further investigation and the Parliamentary Ombudsman would be an ideal person to undertake such an investigation.

Lord Penrose particularly pointed his finger at the GAD which I understand could now be brought into the remit of the PO to investigate based on a statement by the minister Ruth Kelly MP this week. The GAD were "sub-contracted" to by the DTI as the DTI did not have suitable expertise in house and so they were acting under the remit of the DTI and it is important that their role is looked at.

There are various points that I would like to make that were raised by Lord Penrose regarding the regulators, which makes it important that the Parliamentary Ombudsman should make a full review.

1. Lord Penrose states "There was a general failure on the part of the regulators and the GAD"
2. He also states that during 1998 he felt that GAD's approach had been persistently naïve". He also calls them 'complacent' and states "that short-term objectives related to support of solvency that should have alerted regulators to the Society's weakening position."
3. During the period of the early 1980s through to the end of 1998 he states that both the DTI and the Treasury who had been responsible for prudential regulation over the period were 'ill equipped', they did not use information they had to appraise the Society's financial position and they accepted unsatisfactory answers without ever following them up.

It appears that Equitable was allowed to accrue large liabilities by not ring fencing the non GAR (GAR - Guaranteed Annuity Rate) policyholders from the GAR policyholders and not telling non GAR policyholders that the GAR existed. This was further exacerbated by the fact that the Society was failing to reserve for the GAR, which also seems to have been overlooked by the regulator. The House of Lords ruled that Equitable's decision to pay differential bonuses to the different type of policyholders was endorsed by the regulators.

Lord Penrose also states that Equitable was able to produce inadequate accounts and returns which obscured the underlying problems, the regulators failed to recognise the inadequacy of the re-Insurance policy negotiated by Chris Headdon in the late 1990s to cover reversionary bonuses for the GARs, they allowed Equitable to 'over bonus' over several years in spite of the fact that there were totally inadequate reserves. This should have been stopped by the regulators as the fund was a with profits one and by definition it requires a smoothing process for which the reserves appear to have

been totally inadequate. Equitable stated that they were selling a low risk product, but this was definitely not the case and the result of this can now be clearly seen by the plight of the with profit annuitants.

I do hope that you take this opportunity of extending your inquiry, as a terrible wrong has been done to innocent policyholders and it would be good for all concerned to actually find out exactly where the failures were. Equitable is now automatically mentioned in the press as one of the major financial scandals, it does deserve some more in depth investigation.

I hope that you are able to get assistance from Lord Penrose and that he has not gone totally into retirement, as he must now be one of the most knowledgeable people with regards to Equitable Life.

Liz Kwantes

## Submission from the **Equitable Life Assurance Society** (20 May 2004)

Questions for discussion at meeting with Parliamentary Ombudsman on 25 May 2004

1. Should the Parliamentary Ombudsman carry out any further investigation into the regulation of Equitable Life, to the extent that she has jurisdiction to do so?

Yes.

2. If ELAS considers that the Ombudsman *should* carry out a further investigation:

(a) On what grounds does ELAS seek to persuade the Ombudsman that she should do so?

The purpose of the office of the Ombudsman is aptly summed-up by one of the leading works on public law:

*'[T]here is a large residue of grievances which fit into none of the regular legal moulds, but are none the less real. A humane system of government must provide some way of assuaging them, both for the sake of justice and because accumulating discontent is a serious clog on administrative efficiency in a democratic country.'*(Wade & Forsyth, *Administrative law*, 8th Ed 2000, page 87)

The Ombudsman has the task of investigating complaints by members of the public that they have sustained injustice as a result of maladministration by bodies subject to investigation by her (s 5 PCA 1967). 'Maladministration' was defined by Sedley J in *R v Parliamentary Commissioner for Administration ex parte Balchin* [1998] 1 PLR 1, 11 B-E:

*'it is accordingly accepted that maladministration includes bias, neglect, inattention, delay, incompetence, ineptitude, perversity, turpitude and arbitrariness in reaching a decision or exercising a discretion, but that it has nothing to do with the intrinsic merits of the decision itself'*

The meaning of injustice was considered in the same case, and Sedley J adopted the definition provided in *De Smith Woolf & Jowell's Judicial Review of Administrative Action*, 5th Ed 1995, at paragraph 1-102:

*''Injustice' has been widely interpreted so as to cover not merely injury redressible in a court of law, but also 'the sense of outrage aroused by unfair or incompetent administration, even where the complainant has suffered no actual loss''*

The matters complained of in this submission fall within the Ombudsman's remit, and are apt for investigation by her as real grievances that, at least as a matter of practicality, are not justiciable in the courts.

Further, it is appropriate for the Ombudsman to carry out the investigations requested, for the following reasons.

Firstly, the Ombudsman enjoys jurisdiction to investigate the acts and omissions of DTI, HMT, FSA, and GAD in their prudential regulation of the Society.

Section 4(1) PCA 1967 provides

*'Subject to the provisions of this section and to the notes contained in Schedule 2 to this Act, this Act applies to the government departments, corporations and unincorporated bodies listed in that Schedule; and references in this Act to an authority to which this Act applies are references to any such corporation or body.'*

Both the 'Department of Trade and Industry' and the 'Treasury' are listed in schedule 2 to the Act.

GAD falls within the Ombudsman's jurisdiction.<sup>1</sup> In brief:

(a) GAD is a subordinate department of the Treasury. Note 6 to Schedule 2 to the PCA 1967 provides

*'... Any reference to the Treasury includes its subordinate departments and the office of any Minister whose expenses are defrayed out of monies provided by Parliament for the service of the Treasury'*

(b) GAD acted at material times as the agent of the regulator. Section 5(1) PCA 1967 provides

*'... the Commissioner may investigate any action taken **by or on behalf of** a government department or other authority to which this Act applies, being taken in the exercise of administrative functions of that department or authority ....'*

(the Society's emphasis). The Penrose Report neatly summarises the position at paragraphs 19/157ff<sup>2</sup>, in a section on the regulatory regime to which the Society was subject headed 'Structure and Resources':

*'Until the late 1990s, the regulatory system involved the delegation by the responsible authority (successively DTI, HMT, and FSA) to GAD of the essential task of actuarial scrutiny of life offices' returns. This persisted until FSA brought the separate elements together and began to implement an integrated regulatory system. Until that reorganisation, GAD reported to the regulator, initially in terms of service level agreements that defined the scope of the delegated duties.'*

An example of the reality of the situation is given by a letter of Chamberlain of GAD to Ranson of 3 April 1996, in which he records the heavy reliance placed upon GAD by DTI [16/188].

Further, commentators support the proposition that s 5(1) PCA 1967 brings within the PCA's jurisdiction bodies exercising functions delegated to them by government departments (see for example Seneviratne, *Ombudsmen*, 2002, pg 103; *Wade*, pg 87ff). It would be strange if the PCA's jurisdiction could be removed by virtue simply of a government department delegating relevant powers.

As to the FSA, the Society agrees with the decision reached by the PCA in PREL<sup>3</sup> (at paragraphs 3 ff of the Full Text), that the FSA is subject to investigation in respect of its prudential regulation of the Society. This is clearly correct.

Secondly, there seems to be no dispute that the other preconditions for the exercise of the PCA's jurisdiction, set out in section 5 PCA 1967, are satisfied.

Thirdly, the failures of GAD and the regulator highlighted by the Penrose Report are not simply bad decisions taken without maladministration. Each failure complained of constituted or directly resulted from an act or acts of maladministration.

Further, general circumstances strongly suggest that an investigation is appropriate. There is wide public concern about the acts and omissions of the regulators and GAD in their prudential regulation of the Society. The Penrose Report provides clear prima facie evidence of maladministration causing injustice. No proposals for redress have been made by the relevant departments. The Ombudsman enjoys powers under ss 8 and 9 PCA 1967 that were not available to the Penrose Inquiry; the lack of such powers on occasion hindered it (see for example 19/174). The Ombudsman enjoys the ability to make proposals for redress. There is no other realistic prospect of redress for those policyholders who have suffered injustice as a result of the maladministration of GAD and the regulator.

In the premises, the conditions for further inquiry set out by Sir Michael Buckley in his Supplementary

<sup>1</sup> See also the reasons set out in the Statement of Grounds in the application for judicial review made by EMAG.

<sup>2</sup> In this submission references to paragraphs of the Penrose Report are made in the following fashion: the number of the chapter is given, followed by the paragraph number of the paragraph in that chapter referred to.

<sup>3</sup> Report of the Parliamentary Ombudsman into the Prudential Regulation of Equitable Life, printed on 30 June 2003.

Memorandum to the Select Committee on Public Administration of 30 April 2002 are fulfilled: there is strong evidence in the Penrose Report of unremedied injustice to individuals caused by maladministration by bodies within the Ombudsman's jurisdiction and the absence of proposals to remedy that injustice. The Ombudsman herself, correctly, adopted this approach in her letter to Members of Parliament dated 5 December 2002. Investigation would help lead to the fulfilment of one of the aims of the Ombudsman, set out in the first paragraph of the PCA Business Plan, 2002: to achieve appropriate redress for grievances found to be justified.

**(b) In respect of which matters and over which period should any further investigation be undertaken?**

(i) In his report, Lord Penrose details at length how the prudential regulators ie, the DTI, the Treasury ("HMT"), and the FSA approached their supervisory task; how they responded to, and dealt with, the various issues that arose over the relevant years; and the way in which they resolved the supervisory dilemmas that they inevitably faced as the crisis developed [15/3]. These matters should all be investigated. GAD acted on behalf of DTI, HMT, and FSA and should be included in the investigation.

See Chapters 15 to 18 of Lord Penrose's report.

(ii) The most important aspects of those chapters are that the regulators -

– Knew that during the late 1980s and 1990s, the Society's capital was diminishing to a dangerously low level. In effect, the regulators allowed the Society to trade with inadequate reserves and they ought to have insisted on appropriate corrective action;

– Failed to challenge the lawfulness of the terminal bonus policy despite knowing of it at the time it was introduced in 1993 [16/116-118], or that it might be contrary to Policyholders' Reasonable Expectations [16/116];

– Failed to act on the early knowledge that the Society was not reserving for the guarantees expressly contained in the GAR policies [16/116-117]. Again, they ought to have insisted on proper reserves.

– Each of these amounts to a serious regulatory failure and maladministration. If the regulators had intervened in respect of these matters, the problems that beset the Society and its policyholders would have been prevented.

(iii) The period that should be investigated is from 1989, when the bonus system was changed [16/8 and 16/16], to December 2000 when the Society closed to new business.

**(c) If it does, why does ELAS consider that it would be in the public interest for the Ombudsman to carry out, at substantial expense, a further investigation and to submit a report to Parliament, having regard to the wide ranging investigation carried out by Lord Penrose and his detailed report, which is already before Parliament?**

Lord Penrose did not address the question of whether anyone had sustained "injustice in consequence of maladministration". As he said in the postscript to his report [20/77], it was no part of his inquiry to answer the questions "who is at fault for the problems encountered by the Society, and who deserves redress as a consequence". But he did conclude that the regulatory system did fail policyholders; and that the jurisdiction to adjudicate on regulatory failure in duty was not his; and it was not for him to comment on how the government should respond if it were to acknowledge that there had been regulatory failure. [See 20/83-84].

As stated above, the Penrose Report provides clear prima facie evidence of maladministration causing injustice. No proposals for redress have been made by the relevant departments. The Ombudsman enjoys powers under ss 8 and 9 PCA 1967 that were not available to the Penrose Inquiry; the lack of such powers on occasion hindered it (see for example 19/174). The Ombudsman enjoys the ability to make proposals for redress. There is no other realistic prospect of redress for those policyholders who have suffered injustice as a result of the maladministration of GAD and the regulator.

An investigation by the Ombudsman would save considerable cost and expense for those policyholders who wish to make a complaint and who would otherwise be left with no other choice than to contemplate formal legal action against the regulators - with, as the Society is advised, no real prospect of success. The Ombudsman will complete her investigation quickly; much quicker than any court action could be concluded.

There is a widely felt and public concern that the question of whether the regulators were guilty of maladministration has not yet been addressed or determined. It is in the public interest to establish whether there has been maladministration and whether there has been injustice in consequence.

Those are matters for the Parliamentary Ombudsman.

**3. Does ELAS accept Lord Penrose's conclusion that the Society was principally the author of its own misfortunes? If not, why not?**

The Society does accept that there were serious deficiencies in the way in which it was managed during the time it was under the control of the old board of directors. But the role of the regulators was (and is) to keep a check on the management of the Society, and especially its management of its financial affairs, so that it was in a position to protect policyholders from the consequences of management deficiencies.

See, for example, the DTI brief from the late 1970s which stated -

*"the main purpose of insurance supervisory legislation is to protect the public from loss through the insolvency, dishonesty or incompetence of an insurer." [15/8]*

The primary objective of the insurance division of the DTI was defined in a Service Level Agreement between the DTI and GAD as follows -

*"regulate the insurance industry effectively (within the duties and powers set out in the [1982] Act) so that policyholders could have confidence in the ability of UK insurers to meet their liabilities and fulfil policyholders' reasonable expectations." [15/7]*

The FSA summarised the objectives of regulation in a statement prepared for Lord Penrose as -

*"to protect policyholders against the risk of companies being unable to pay valid claims. In the case of life insurance companies, this includes the risk that they will be unable to meet policyholders' reasonable expectations." [15/7]*

Lord Penrose's report sets out in great detail how the regulators knew enough of the management deficiencies of the old board to be in a position to ensure that matters were rectified but failed to take steps to do so - and so failed in their duties. See, for example, the report at 16/21.<sup>4</sup>

**4. We note that you have been advised that 'the findings in the [Penrose] report provide grounds for encouraging the Parliamentary Ombudsman to carry out a further investigation'. Does ELAS think that this is consistent with the statement in the same advice that 'it cannot be said that the regulator failed to consider whether to exercise its powers of intervention under the ICA 1982 or that no rational prudent regulator could have acted in the way in which it did'? If so, on what basis does ELAS take this view?**

The second passage set out above from the letter dated 14 April 2004 from Herbert Smith comes from the section in the letter explaining (very briefly) the firm's view and the view of counsel that the Society does not have any claim against the regulators for breach of statutory duty under the ICA 1982.

It is an entirely separate and different question to consider whether the regulators were guilty of maladministration and whether that maladministration has led to injustice. Those questions are for the Parliamentary Ombudsman and should be addressed by her. She is able to consider cases where no other remedy is available.

**5. Does ELAS contend that regulatory systems deficiencies and/or operational failure by regulators caused or contributed to any loss incurred by the Society or by others? If so, please identify the loss(es) concerned and explain the basis for this contention.**

The Society is not in a position at present to comment on questions of loss as a consequence of any findings of maladministration that may be made by the Ombudsman. There are several reasons:

<sup>4</sup> Paragraph 21 states: "Burt [a principal actuary with GAD] then ended with a surprising conclusion about the way forward: 'At present we do not have enough information about the society to be more specific and indeed, unless the society makes more signals, we do not suggest that further information should be sought. The society is our longest established life company and is well respected in the market.' The Society, it appears, was too venerable to be of real concern, and lack of information provided grounds for inaction. The risk of undermining market confidence in the Society appeared to influence regulators at later stages as well as at this time. Regulators had been given an insight into the Society's practice that might reasonably have alerted them to a need for monitoring of current and future practice. No special steps were taken to put in place a suitable system."



- Until the Ombudsman has decided the logically prior questions of whether the regulators were guilty of maladministration and in what respects and during what periods, it is impossible to deal with questions of what loss was suffered in consequence.
- The Society does not know the facts relating to the policyholders whose claims the Ombudsman would be considering.
- Issues as to loss, causation and quantum will be difficult and will need to be dealt with in the light of all the findings of fact that the Ombudsman will make in the matter.

The Society is firmly of the view, however, that losses caused by the falls in the equities and other investment markets should not be eligible for compensation.

The Society would wish to make submissions on questions of loss at the appropriate time.

## 6. What are the views and conclusions expressed by Lord Penrose with which ELAS has difficulty and does not accept?

There are many matters of detail in the report with which the Society has difficulty and does not accept. None of those details are relevant to the matters that the Ombudsman would have to consider in the course of any investigation, and therefore it is unnecessary for present purposes to go into any of them. It may be helpful to note that the Society does not accept much of the detail and the conclusions set out in chapter 6 of the report.

On the other hand, the Society does accept Lord Penrose's views and conclusions relating to the regulation of the Society during the second half of the 1980s and the 1990s. Those are the matters with which the Parliamentary Ombudsman would be primarily concerned if she were to carry out a further investigation into the regulation of the Society - as we urge her to do.

## Letter from Herbert Smith on behalf of Equitable Life (11 June 2004)

### The Equitable Life Assurance Society

We are instructed by the Equitable Life Assurance Society ("the Society").

We understand that, following your meeting with representatives of the Society on 25 May 2004, you requested further details of the Society's position in respect of one issue arising out of our and Counsel's advice to the Society as summarised in our letter of 14 April 2004. That issue was whether our advice that the findings in the Penrose Report provide grounds for encouraging you to carry out a further investigation (page 5 of our letter), is consistent with our advice that:

*"it cannot be said that the regulator failed to consider whether to exercise its powers of intervention under the Insurance Companies Act 1982 or that no rational prudent regulator could have acted in the way in which it did" (page 2 of our letter).*

Since your query relates to our letter of advice, the Society has suggested that we respond directly to you. We have further consulted Mr Iain Milligan QC and Mr Guy Mopuss of Counsel on this issue, and what we say represents their and our collective views. Mr Robert Miles QC, whose views were also set out in our letter of 14th April 2004, was not available to advise further but we have no reason to assume that he would not concur with what follows.

We do not consider that there is any inconsistency in our advice, for the reasons set out below:-

(1) At page 2 of our letter we were expressing the view that the Society would not succeed in showing that the prudential regulator had behaved irrationally in a public law sense. That is a very different question from whether the regulator: (i) had been negligent; or (ii) was guilty of maladministration. The distinction is evident from Wade & Forsyth on Administrative Law, 7th ed, as follows (at pages 400 to 401):-

*[Irrationality in the public law sense] ... is not therefore the standard of 'the man on the Clapham omnibus'. It is the standard indicated by a true construction of the Act which distinguishes between what the statutory authority may or may not be authorised to do. It distinguishes between proper use and improper abuse of power. It is often expressed by saying that the decision is unlawful if it is one to which*

*no reasonable authority could have come ...*

*Taken by itself, the standard of unreasonableness is nominally pitched very high: 'so absurd that no sensible person could ever dream that it lay within the powers of the authority' (Lord Greene MR); 'so wrong that no reasonable person could sensibly take that view' (Lord Denning MR); 'so outrageous in its defiance of logic or of accepted moral standard that no sensible person who had applied his mind to the question to be decided could have arrived at it' (Lord Diplock) ...*

It will be apparent from those passages that the test which we were considering at page 2 of our letter is a high one. All that we were saying at page 2 was that that test was not satisfied.

(2) The test for negligence is less high; and that for maladministration lower still. As to the latter:-

(a) In *R v Parliamentary Commissioner for Administration, ex Balchin* [1998] 1 PLR 1, it was said that:-

*... maladministration includes bias, neglect, inattention, delay, incompetence, inaptitude, perversity, turpitude and arbitrariness in reaching a decision or exercising a discretion ...*

(b) In *R v Local Commissioner for Administration, ex Liverpool CC* [2001] 1 All ER 462, Chadwick LJ said:-

*... there is no reason in principle why the considerations which determine whether there has been maladministration should, necessarily, be the same as those which determine whether there has been unlawful conduct. The Commissioner's power is to investigate and report on maladministration; not to determine whether conduct has been unlawful ...*

It should be noted that Chadwick LJ specifically draws the distinction between unlawful conduct - which would include irrationality in the public law sense - and maladministration.

(c) To similar effect, we note that your predecessor defined maladministration widely to mean poor administration or the wrong application of rules (*About the Ombudsman* (1998)).

(3) Accordingly, the conclusion which we expressed at page 2 of our letter (which was concerned with the narrow question of irrationality in a public law sense) does not touch on the question of whether the prudential regulator was guilty of maladministration in the sense set out in (2) above. Even if you were to ask yourself the narrower question of whether the prudential regulator had acted "unreasonable", our view on "irrationality" does not assist you.

(4) Where a regulator has acted irrationally in a public law sense it would inevitably follow that it has acted unreasonably and been guilty of maladministration. However, the converse does not follow. The fact that a regulator has acted rationally does not mean that it has not acted unreasonably or been guilty of maladministration.

(5) Our reasons for encouraging you to carry out a further investigation (page 5 of our letter) were based on our view that the Penrose Report did provide grounds for concluding that the prudential regulator had acted unreasonably or been guilty of maladministration. We refer, by way of example, to the criticism of the regulator for: (i) allowing the Society to trade with inadequate reserves; (ii) its failure to challenge the lawfulness of the Society's terminal bonus policy after 1993; and (iii) its failure to insist on proper reserves in respect of guaranteed annuities.

We trust that this clarifies the position. We and Counsel remain of the view expressed at page 5 of our letter, and we do not believe that any of the other conclusions which we reached detract from that view.

**Herbert Smith**

## Letter from the **Equitable Life Assurance Society** (15 June 2004)

At our meeting on 25 May 2004, it was agreed that we would ask Herbert Smith and Counsel to deal further with the point you raised at para 4 of the questions you submitted before our meeting. Herbert Smith and Counsel have now written to you, and we trust that you are able to accept what they have said.

We also agreed that we would give further consideration to the matters relating to quantum raised at para 5 of your questions. We have done so, and now turn to these matters.

In the context of a claim before the ordinary courts, as you know, once a court has found a breach of duty owed by the

defendant to the claimant, it then (but only then) goes on to consider what loss, suffered by the claimant and caused by the defendant, should be attributed to the defendant. At that stage, it also quantifies the loss. In other words, issues of causation, remoteness and quantum are considered and dealt with.

As we understand the position, you are able to approach issues of loss in a less formal way, but nevertheless you will no doubt be concerned to be satisfied that any alleged loss was caused by, and is properly attributed to, any act or omission you will have decided amounted to maladministration as a result of your investigation. The issue for you is whether any complainant has 'sustained injustice in consequence of maladministration' (s.5 of the Act). Injustice will include loss, as well as a sense of outrage. But the loss or sense of outrage must have been caused by, or suffered in consequence of, the maladministration.

It follows that issues of loss cannot be considered in isolation from the maladministration. Given the breadth of the investigation it is proposed that you should carry out, including the lengthy period of time involved, there are many possible areas of regulation in relation to which a finding of maladministration could be made. Each such potential finding will raise its own issues of loss, causation and remoteness. In relation to each such finding, consideration would have to be given to what would have happened if there had been no maladministration before going on to consider loss, causation and remoteness. It is because of the sheer breadth and extent of the task that we suggested in our response to your questions that we should not at this stage comment on those issues.

Where courts are faced with complex issues relating to loss, it is now commonplace for there to be a split trial: the first trial dealing with liability and the second dealing with loss and related issues. We suggest that your questions relating to loss should be addressed in an analogous way and deferred until you have considered whether there has been any maladministration and what would have happened if there had been no maladministration. At that stage, we would be anxious to assist you by making appropriate submissions.

At this stage, however, we can appreciate that you may be reluctant to embark on a new investigation if you consider it unlikely that at the end of the day any significant loss will have been suffered by anyone. But it seems to us that it is easy to see how losses may have been suffered as a result of maladministration. Thus, for example, let us suppose that in due course you find maladministration; and that if there had been no maladministration, the regulators would have acted, by intervention or in some other way, to require the Society to close to new business by a certain date. It would follow that all policyholders who in fact first effected a contract with the Society after that date, would not have done so. Many of them may well be able to show that if they had not effected their contracts with the Society, their financial position would be better than it now is (excluding losses attributable to falls in the equity markets). In other words, they will be able to show that the relevant losses were caused by the maladministration. We cannot be sure of this because, as we stated in our original response, we do not know the individual circumstances of those who may have complained to you (or who may do so in the future). But it seems inherently unlikely that in the circumstances of this case, no loss would have been suffered by anyone as a result of maladministration.

It is worth making the point that the mere fact that the Society remained open to new business and that in consequence the policyholders were able to effect their contracts, does not give them any cause of action against the Society.

**Vanni Treves**  
Chairman

## Letter from HM Treasury (20 May 2004)

EQUITABLE LIFE

Thank you for your letter of 22 April.

You explain that you are considering whether to carry out any further investigation into the prudential regulation of Equitable Life and that you are inviting representations from the Treasury and other interested parties in order to inform your decision.

The Treasury is grateful for the opportunity to contribute to your consultation process. We, of course, realise that the decision whether to undertake any further investigation remains a matter for you.

The Treasury will, of course, co-operate fully with your Office should you decide to carry out any further investigation.

## Findings of fact

You ask specifically the extent to which the Treasury accepts the findings of fact in Lord Penrose's report.

Lord Penrose's report presents a narrative of the events at Equitable Life over many years. His purpose was to discover what had led to the situation of the Society as at 31 August 2001 so as to learn lessons for the future. As he makes clear in the postscript to his report he was not seeking to provide answers to the questions of 'who is at fault for the problems encountered by the Society, and who deserves redress as a consequence?' (Chapter 20, paragraph 77). In the foreword to his report he notes that;

*“Breach of duty, and the financial consequences of breach, are properly matters for the established courts of justice and for other appropriate tribunals in the financial sector, to be dealt with in accordance with rules of procedure that take account of the interests of parties, typically focused in adversarial terms.”*  
(Foreword, paragraph 9).

We do not, therefore, believe that any investigation seeking to determine whether there had been maladministration resulting in an unremedied injustice can proceed solely on the basis of the narrative set out in the Penrose report. The report does not make findings of fact which it would be open to you simply to adopt. It will, in our view, be necessary, if you decide to undertake such an inquiry, for you to undertake a full investigation by your Office in order to reach your own view on issues of maladministration.

It is also perhaps worth noting the complexity of much of the material that would have to be examined. In this context the findings of over allocation of bonus by Equitable, which forms one of the main conclusions of Lord Penrose's report, provide a particularly difficult example. Lord Penrose drew the information for this section of his report from figures held by Equitable. However, working from the same basic data, we understand that Equitable Life itself and its advisors strongly dispute that any inappropriate bonus allocations were made. Lord Penrose accepts that the financial analysis exercise he carried out on this information in order to reach his conclusions was 'necessarily crude' (chapter 6, paragraph 54), this provides one example of how the issues raised in this case give rise to extremely complex policy, legal and actuarial questions and that very different interpretations can be legitimately placed on the available factual material.

Therefore, while in the event of your deciding to undertake a further investigation into the regulation of Equitable the Treasury will, as noted above, give your Office its full co-operation, it is important to recognise that the extent of the task facing you would be enormous and that difficult questions of both fact and judgement will arise for you in many areas.

## Period and matters of any further investigation

You also ask for our views as to the period and matters which should be covered if you were to carry out a further investigation. If you were to decide to undertake a further investigation these would, of course, be matters for you to decide.

In our view, given Lord Penrose's conclusion that the problems at Equitable go back over a considerable period of time (at least to the late 1980s), it would be very difficult to limit the period of any investigation. We would, therefore, suggest that, if you were to undertake any further investigation, it would be necessary for such an investigation to cover the whole period examined by Lord Penrose. It appears to us that limiting any investigation to a more focused period would prevent you from reaching meaningful overall conclusions which would be generally defensible.

However, with regard to the period (1999-2000) covered by the report you published in July last year, we think it is worth pointing out that, as far as we are aware, you received the same documentary material as Lord Penrose (at least as far as the regulators were concerned) and had the opportunity to interview any relevant members of staff. We do not believe that any new facts relating to this period have emerged from the Penrose report. Therefore, we would suggest that there are no grounds for re-examining the period covering the investigation already undertaken by your Office although doubtless if you investigate events prior to 1999 you will be faced with calls to re-open your first investigation.

## Other points

### Jurisdiction

We believe that the restrictions on your jurisdiction which you referred to in your earlier report continue to be material. As you observed in the overview section of that report:

'I could look at only a very small part of what is a much larger and more complex picture. My predecessor had expressed strong reservations as to whether such a restricted investigation could properly establish the key determinants in these events and the lessons to be learned from them.'

We have, of course, discussed the possibility of extending your jurisdiction to cover the Government Actuary's Department (GAD). The Government has agreed to consider such an extension if you were to request it.

However, we understand that it would not be possible to extend your jurisdiction to cover Equitable Life, Equitable's auditors and other advisers or the Personal Investment Authority (or its predecessor bodies). None of these bodies would appear to fall within the categories of bodies which can be brought within your jurisdiction under the 1967 Act.

Therefore, even if the Government were to agree to the extension of your jurisdiction to cover GAD it would remain the case that many of the most important parties would remain outside it. This means that any investigation which you were to undertake would, necessarily, be less comprehensive than that already carried out by Lord Penrose. Given that, as you yourself have said, the role of the regulators is only part of a large and complex picture it is not clear to us how an investigation which looked only at the prudential regulators (and possibly GAD) could properly reach definitive and generally defensible conclusions. You may also wish to consider, in this context, whether a further inquiry into this issue at public expense represents value for money given its, necessarily, limited remit.

### **The nature of the regulatory failure**

Lord Penrose clearly states that the regulatory system failed policyholders in the case of Equitable. I accept this.

However, Lord Penrose also says that this was not:

*“. . . because of individual failures. I do not pin that blame on individuals, who in the main have operated in good faith and to the best of their abilities within the system as they found it.” (Chapter 20, paragraph 83).*

The regulatory failure was, therefore, one of the overall system rather than at the operational level. The system failures described were due to the policy adopted by previous governments and approved by Parliament. It is our understanding that maladministration covers the failure of a department to properly operate a system rather than any deficiencies which might exist in the policy being implemented by that system.

### **Hindsight**

Lord Penrose makes clear that he made full use of hindsight:

*“I have the benefit of hindsight, and I have not restricted the comments made to those matters that can be shown to have been within the knowledge or contemplation of individuals or groups at material times.” (chapter 19, paragraph 2)*

The comments made in the Penrose report about the regulators must be seen in the light of this. Having the benefit of hindsight is appropriate when considering the lessons to be learnt from particular events. However, it means that the comments Lord Penrose made do not necessarily provide evidence as to whether the regulators performed their duties properly based on what would have been expected or known about at the relevant time. We would submit that this provides further support to our view, set out above, that if you were to undertake a further investigation it would be necessary for you to conduct a full examination of the facts with a view to reaching your own conclusions about the matters being investigated.

### **Ongoing legal and other actions**

As you are aware, Equitable Life are undertaking ongoing civil proceedings against some of the former directors and auditors of the Society. Equitable has, however, concluded that it has no case against the regulatory authorities.

You may also be aware a group of with-profits annuitants have recently announced that they intend taking legal action against the Society.

The Financial Ombudsman Service (FOS) is, we understand, considering a substantial number of complaints from policyholders and ex-policyholders (continuing policyholders are barred from complaining about GAR related issues by the terms of the compromise agreement).

The existence of these proceedings and the FOS investigations suggest that a number of routes remain open for investors in Equitable who believe that they have a case for compensation.

## Effect on Equitable Life

We would also suggest that in deciding whether to proceed with a further investigation you should consider the potential wider effects of such an investigation, which on the basis of the previous investigations is likely to take several years to complete, on both Equitable Life and the procedures for dealing with complaints against financial sector regulators.

The setting up of further investigation is likely to prolong the uncertainty surrounding Equitable. This could hinder efforts by the company to settle outstanding issues and return to stability. Continued uncertainty may also cause further distress to policyholders.

No doubt you will also have in mind your overall role, responsibilities and workload in considering whether to undertake any investigation into issues surrounding Equitable Life. It is possible that doing so would lead to your Office being asked to intervene across a wide range of complex financial services issues by investors who feel they have lost money unjustly. As you are aware these areas are largely outside your jurisdiction and the Government has set up a structure under the FSA, FOS and FSCS - including a Complaints Commissioner for the FSA - to deal with such issues.

### Ruth Kelly MP

Financial Secretary to the Treasury

## Letter from Financial Services Authority (letter of 21 May 2004)

### EQUITABLE LIFE

I am writing to take up your invitation to make representations on whether, and, if so, in respect of which period and matters, you should carry out any further investigation into the supervision of Equitable Life. Although we discussed this with HM Treasury, (on whose behalf we conducted prudential supervision of Equitable Life from 1 January 1999 to 30 November 2001) this letter is sent solely on behalf of the FSA.

We fully understand the reasons which led you to consider conducting a further investigation, and indeed why there have been calls on you to do so. But we believe that there would be very substantial difficulties in your doing so, and significant public interest detriments, without any substantial basis for believing that this would achieve the purposes which those advocating it would seek. We would therefore ask you not to conduct a further review for any period, and most particularly consider that it would be very difficult for you to justify conducting a further review of the short period for which we were responsible for the prudential supervision of the company. You yourself have already reviewed this, without finding maladministration.

I should start by saying that we see no benefit in a further review from the viewpoint of enhancing the future effectiveness of the regulatory system. We learned very substantial lessons from our own internal audit review, conducted with external support by Ronnie Baird and published in September 2001. As a result of those lessons, we have made substantial changes to the way the regulatory system operates which were supported by Lord Penrose in his report. We have also made further changes in the light of that report, which was able to look at the period before we took over prudential supervision of the company, and been able to study your own earlier report. We consider the likelihood that a fourth review of the same events will produce further significant reforms to be very low. There would also be, inevitably, public interest detriments from a further significant diversion of resources, including senior management and legal resources, away from ongoing supervision and risk mitigation.

We recognise that the purpose of a further review by your office would be to look for maladministration on which the Government could be recommended to pay compensation. But for the period of our own responsibility, we do not think that the Penrose report undermines your own earlier conclusions that the FSA, acting as prudential regulator on the Treasury's behalf, 'cannot be said to have acted maladministratively and to have caused the injustice which the complainant alleges', which we consider to have been a proper judgement, reached after thorough investigation.

We also consider that a further review would face considerable difficulties of practice and principle. Lord Penrose undertook a very wide-ranging review, which considered the position of all those involved over the full period at issue. This work involved study of many thousands of documents, took several years and led to a report of over 800 pages. But in spite of the intellectual rigour and expert advice he was able to bring to bear, he was clear that 'breach of duty and the financial consequences of breach are properly matters for the established courts of justice and for other appropriate tribunals'. We respectfully endorse this conclusion.

In this context, it makes sense to respond to your enquiry about the extent to which we accept 'findings of fact' in the

Penrose report. As we see it, the Penrose report does not make findings of fact in the way that a court could be said to do so. Its terms of reference are clear, that its purpose was to examine events and learn lessons. We believe that it achieved that purpose very well, but are equally clear that the descriptive material in the report, however useful it may be in assisting lessons to be learned, cannot be regarded as making findings of fact from which conclusions on the existence or breach of duties or on maladministration could be drawn. ('I have been able to produce an account of what happened . . . It will be for others to consider in an appropriate forum, and in the context of the facts found according to the practice of that forum, whether fault occurred . . .'). The courts have made very clear in the BCCI case that this is the approach that they would take to considering descriptive material in such reports. We similarly consider that descriptive material in the Penrose report could not be relied on to make a finding that maladministration had occurred.

I should also express concern about a further public interest detriment which would arise from a decision to conduct another review. We have a very keen interest in being able to recruit and retain high quality staff. There are now very few individuals still with FSA who might be asked to give evidence. But equally many of those of our former staff whom you might need to interview will have given evidence previously to three earlier inquiries, the Baird and Penrose inquiries, both designed to learn lessons for the future, and your own previous inquiry, looking for maladministration. A fourth inquiry could quite legitimately be regarded as oppressive and it is important to recognise that potential exposure to a series of inquiries would undoubtedly be a deterrent to anyone considering working as a regulator.

Finally, of course, your jurisdiction is quite properly limited to public bodies, and so would not extend to regulation conducted by the Personal Investment Authority and its predecessor self-regulatory organisations. Although we understand that the Government has indicated that it would consider extending your jurisdiction retrospectively to cover the Government Actuary's Department, we think that different issues would be raised if it were to be suggested that it could retrospectively extend your jurisdiction to self-regulatory organisations. It therefore seems to us unlikely that a new inquiry on your part could ever be as comprehensive as the Penrose review, even in its coverage of regulators.

**Callum McCarthy**  
Chairman

## Second letter from **Financial Services Authority** (7 July 2004)

EQUITABLE LIFE

I very much appreciated the opportunity which you gave Andrew Whittaker and me at our recent meeting to expand on the FSA's concerns about the possibility of a further review of the supervision of the Equitable.

In this letter I want to reinforce my reasons for believing that a further review now would not be in the public interest. The key issues raised are not about us, but about the impact on consumer confidence and on consumers themselves.

As I said when we met, there is no evidence or reason to believe that a further review would help restore consumer confidence in the insurance industry or in its regulation. If anything, the reverse is true, with a long period of uncertainty (as you know, I see no grounds to believe that a review conducted by your office could be other than lengthy) distracting attention from making the new system work, and risking confidence in the new system being undermined by lack of confidence in its predecessor.

I also believe that a further review would raise consumer expectations which in reality it could not meet, because it is very unlikely to be able to conclude that there was maladministration or that it was maladministration that caused any loss suffered.

We think it would be difficult to find maladministration, because:

- Lord Penrose not only did not make a finding a maladministration in the operation of the previous system; indeed he found that it was the system itself that was at fault;
- This makes it difficult to find that there was maladministration, because no one can expect a system which is fundamentally flawed to produce the results of an effective system; and
- The basis on which you could find maladministration is not, as I understand you to believe, substantially different from that on which regulators could be held liable in the courts, when the Equitable itself has been advised that such a claim would be unsuccessful.

We also think that there is real doubt about whether any loss can in fact be attributed to the regulatory system. On Lord Penrose's view, many policyholders were in fact paid out more than their asset share. While others will get less than they had come to expect, it is very unclear, even after considerable analysis by legal and actuarial experts, that this can be shown to result from any culpable conduct by the company itself. Still less is there any clear link with the regulatory system in allowing such conduct to take place. We think it much more likely that losses were in fact caused by a combination of a full distribution policy, about which the company made no secret, and very substantial falls in the equity market which as a result of this policy the company had no cushion to absorb. I should make it absolutely clear that I am not, trying to defend the regulatory system we inherited. We have made the case for change and are well on our way to completing a fundamental programme of reform. What we are questioning is the causative link between the way the old system operated and any losses that policy holders may have suffered.

So we think that the reality is that this is a case in which you are being asked to make findings on maladministration where it is the system itself which is in question. But as you will recognise, this would potentially lead to you being asked to look at every company regulated under the old system - a position which would clearly be unsustainable.

I know that you will consider these points seriously before embarking on a further and no doubt lengthy review. Of course, if you do conduct a further review, we will cooperate with it fully. I am also happy to confirm as you requested that my earlier letter, and indeed this letter, can be made public.

**Callum McCarthy**  
Chairman

## Letter from the Department of Trade and Industry (11 May 2004)

EQUITABLE LIFE

Thank you for your letter of 22 April.

You ask about the extent to which the DTI accepts the findings of fact in the Penrose Report and for any written representation the DTI may wish to make. As the Penrose Report and Government response made clear, the DTI transferred to HMT all responsibility for the prudential supervision of insurance companies in January 1998. The Treasury acquired all the relevant papers together with DTI staff at that point engaged in insurance company supervision. So I have a nil return for you.

I should perhaps add that the Report did raise issues of corporate governance and accounting practices for which the DTI does have policy responsibility. Ruth Kelly outlined at the time of publication of the Report, measures to consider these elements more closely - asking the Accounting Standards Board to look at accounting for with-profit insurance policies, and Paul Myners to consider corporate governance issues for mutuals. Needless to say, I am entirely happy with these measures. Lord Penrose also recommended that there should be an authoritative statement on the rights, duties and privileges of directors. The Government accepted the need for a statement of director duties in the Modernising Company Law White Paper of July 2002. The intention is to legislate as soon as parliamentary time allows through a Bill to modernise company law.

**Sir Robin Young**  
Permanent Secretary

## Email from Mr Robert Lewis (16 May 2004)

### Prudential regulation of ELAS

I wrote to you on the 28th January 2004 outlining my reasons why I thought it would be wrong for you to reopen your investigation into the prudential regulation of Equitable Life. You were kind enough to respond to my letter, although not to reply to the specific issues I raised. In light of your request for "interested parties" to write to you on this matter, I have taken this opportunity to send you a second missive reiterating and expanding upon some of the issues I raised in light of the Penrose report. I hope that you do not find these letters too presumptuous; I simply aim to be of some assistance in the difficult decision that you have to make.



## Limits on Jurisdiction

Ironically, the limits on your jurisdiction were clearly enunciated by you in the report on the Prudential Regulation of ELAS and your recent appearance before the Public Administration Committee (27 November 2003).

Your jurisdiction only extended to the prudential regulation of ELAS ; it did not cover the actions of ELAS itself, its auditors, its legal and actuarial advisers. You were unable to review the actions of those charged with regulating the conduct of ELAS business; you did not comment on decisions reached by the courts. As you wrote to Francis Maude MP, "In the event that I were to find maladministration by a body within my jurisdiction, I would be required to consider whether that maladministration had caused injustice and whether the injustice had been or would be remedied. I concluded that it would be impossible for me to decide to what extent any maladministration identified had either caused or contributed to the injustice alleged by complainants in a situation where I was not able in law to investigate the actions of all of the relevant parties."

I also note the EMAG Press Release, 11 March 2004:

*"EMAG maintains that the Parliamentary Ombudsman is the wrong way forward because her remit and jurisdiction is so hopelessly hamstrung. She cannot comment on the GAD or look into the Conduct of Business regulation or even the Society."*

If these factors apply during the period covered by the Baird Report, surely they also apply to the period covered by Lord Penrose? The court of law is the appropriate forum to examine the respective roles of the Law lords, the regulator, the accountants and the management of ELAS. The court of law is the appropriate forum to establish issues of liability and quantum of damages.

If you proceed in the circumstances, which you eloquently articulated in your report, you risk unfairly tarnishing those public servants who worked for the relevant regulatory authorities. The former auditors and directors of ELAS have the opportunity to defend their reputations in a court of law, are you to deny this to the civil servants who worked at the Treasury and the FSA?

## Mutuality and ownership risk

Equitable Life is a mutual company ; it is owned by its members. This has certain financial benefits but also entails certain risks. In a proprietary provider of with-profit policies, shareholders stand behind the fund and are ready to supply capital should it be required. However, they are remunerated for this function. In the 90/10 model, shareholders receive 10 per cent of bonus distributions ; in the 100/0 model, 100 per cent of the bonuses are distributed to policyholders and shareholder returns are instead funded by way of an explicit charge to the fund.

In a proprietary with-profit provider, there is an inherent conflict of interest which may result in adverse financial consequences for the policyholder as regards the allocation of costs, the selection of investment ventures and the distribution of investment returns. ELAS policyholders suffered from none of these financial impediments. (These matters are discussed in considerably more detail in the Sandler Review on Medium and Long -Term Retail Savings in the UK, Chapter 6.) Numerous financial surveys (Money Management, April 2004) indicate that with-profit policyholders receive greater rewards from investing with a mutual, than publicly quoted company. The corollary is that if the fund hits trouble, its members at that time pay the price.

ELAS policyholders sought the economic benefits of mutuality; they now wish to transfer its economic risks onto the taxpayer. They did not want to pay dividends to shareholders but they are now annoyed that they have to shoulder the whole financial burden by themselves. Those who complain that their indicative policy values have been cut, neglect to mention that those same policy values were augmented by the past financial rewards of ownership. In a publicly quoted company, if the board pursues misguided managerial policies its owners, the shareholders suffer economic loss ; in a mutual , its members as owners should suffer likewise. If it were otherwise, then mutuality would become a one way bet and moral hazard would ensue.

People would seek the greater returns of mutuality, knowing that if there are mistakes made by the management, they can claim "misregulation" and the government will pick up the bill.

## Hyman litigation

It is interesting to note that ELAS's differential terminal bonus policy was held to be valid in the court of first instance. The judge concerned was actually a Law Lord. Sir Richard Scott, Lord Scott of Foscote, Vice Chancellor of the Supreme Court and author of the report on illicit arms trading with Iraq. The fact that such an illustrious member of the judiciary should have found in favour of ELAS suggests that their argument was not without merit. In fact, it is surprising that the precise

ambit of ELAS's directors' discretion should give rise to three different definitions (Sir Richard Scott/ Morritt LJ / Lord Steyn). It is also noteworthy that only their Lordship's interpretation would have brought such disruption to ELAS's finances or for that matter the entire life assurance industry.

In the Court of Appeal, Lord Woolf M.R., as he then was, argued that the courts could review the exercise of discretionary power of a private body in the same way as they control administrative discretion via judicial review.

This approach is highly dubious. The State is an involuntary association as citizens of a country are automatically subject to the discretionary power of a public body. Equitable Life is a voluntary association; its members chose to grant its board "absolute discretion" as to how to allocate bonuses in order to benefit from guarantees and smoothing. When the court finds an exercise of discretionary power by a public body illegal or irrational, it engages in the fiction that it is merely declaring what the legal position already is. In reality, the judgment has a retrospective effect; what was apparently legal has ceased to be so. The State with its financial resources can cope with this retroactivity ; a private individual or organisation cannot.

From a factual point of view, it is difficult to reconcile the House of Lord's judgment with the reasonable expectations of non-GAR policyholders as to their asset share and the existence of a class of policyholders entitled to a guaranteed investment return. It should also be noted that at least three other life assurance companies operated bonus policies which were in practical effect the same as ELAS's.

From the point of view of black letter law, it could be argued that Lord Steyn has actually implied a term into a contract which restricts an express term, "absolute discretion". At any rate Sir Guenter Treitel, QC MA DCL FBA, Vinerian Professor of English Law at All Souls, emeritus fellow of All Souls College has also commented on the "novel" features of the case (Law of Contract, 11th edition, pp 212).

As far as jurisprudence is concerned, their Lordships' view runs contrary to the values implicit in the rule of law. As Joseph Raz argues in the Authority of Law, the rule of law demands legal rules are capable of guiding of human action. How were the directors or the regulators to know that the term "absolute discretion" really meant "severely restricted discretion"?

This may help to explain the widespread criticism their Lordships' judgement has drawn from the legal community, including Michael Zander, an Equitable Life policyholder and emeritus Professor of Law at the London School of Economics.

In light of the controversial nature of the House of Lord's decision, can it really be said that the regulators were negligent to rely on their own or ELAS's directors' legal interpretation of the policy documents?

### Over-distribution

Lord Penrose's view is that it was not the GAR issue which brought about the collapse of the Equitable Life but the inherent weakness of the society due to years of overdistribution...

...Firstly, if you accept the fact the cost of the GAR issue was £1.5 billion and there was overdistribution of £3 billion, then the Hyman case made Equitable Life's financial situation 50% worse. A small business which was surviving with thirty thousands pounds worth of debt would not consider a bill for another fifteen thousand pounds a minor issue. And Equitable Life did not have to pay the three billion. The Hyman case created a liability which had to be paid; the difference between policy values and assets did not have to be paid. It also damaged the Equitable brand name and created a run on the society. If the Hyman case had been decided differently, Equitable Life could have brought policies values and assets back into line gradually over the next decade. This is, after all, exactly what the other life assurers are doing right now. The Money Management survey April 2004 illustrates the sharp cuts to policy values across the sector over the past few years which suggests Equitable Life was not the only institution paying out to much in the nineties. Pearl assurance and the life companies owned by Abbey National are in terrible trouble. If overdistribution has occurred throughout the entire life assurance industry, what makes Equitable Life policyholders so special that they deserve compensation? Absolutely nothing.

In this regard, the views of Ned Cazalet, independent life assurance expert, are particularly apposite : "despite the problems, the return on an Equitable pension might be no worse than one bought through any other poorly-performing life offices. Many life offices are paying zero bonuses, so Equitable policyholders may be no worse off than some of those with the competitors ... if that's a case for compensation, I can't see it." (Financial Times 6th / 7th March 2004) Mr Cazalet's views carry weight not only because he has been called as an expert witness by the Treasury Select Committee but he was also commissioned by EMAG to produce "An evaluation of the financial position of Equitable Life" (5 December 2002). The fact that one of the experts hired by the most vociferous policyholder group demanding taxpayers' money doubts their case speaks for itself.

One of the interesting revelations in the Penrose report was his insight into the germination of the EU 3rd Life directive. It appears that a provision that life assurance companies should be under a legal obligation to reserve for the unguaranteed terminal bonus was rejected by the member states at the behest of the then United Kingdom government. To my mind, the concept of maladministration means the poor or negligent implementation of government policy. The truth of the matter is that the regulatory authorities correctly administered this aspect of policy ; it was the policy itself which had unfortunate results. One should also consider the implications of the converse policy. If Equitable Life had reserved for the likely value of terminal bonus, the fund would have consisted of higher proportion of assets displaying lower volatility, for example cash, bonds and property. This would have resulted in a lower overall return for the period. Equitable Life policyholders want things both ways; they want policy values predicated on a fund with a high proportion invested in volatile equities and then they effectively argue that the terminal bonus should have been backed by low yielding assets.

Equitable Life policyholders chose to invest in a with-profit policy, rather than a unit trust, investment trust or for that matter a unit-linked with-profit policy. They chose to place their money in an investment vehicle which gave a wide degree of discretion to the management as to what their return should be. Furthermore, the right to asset share, in its strict sense, and the guarantee are incompatible in the context of a fund where there is a fixed set of financial contributors. The money to fund the guarantees has to come from somewhere.

If you accept that there was over-distribution during the nineties, it is useful to ask where the beneficiaries of such generosity are now. Some of these policyholders have no doubt left Equitable, but others have stayed and taken up standard annuities, with profit annuities or entered the income drawdown scheme. In the later two cases therefore, the cuts to income or policy values that they have experienced have to be set against the amount they benefited from over-distribution. As far as those on standard annuities who were previously holders of policies with Equitable Life which matured in the nineties, either they have been unjustly enriched and their incomes should be cut accordingly or they have not in which case no legal wrong has been committed and no redress at the taxpayers' expense is due to those who claim they have received less than their asset share.

### Barlow Clowes

Much has been made about the alleged precedent set by Barlow Clowes. It seems to me that there are significant differences between this affair and Equitable Life. In Barlow Clowes, the claimants were simply clients of the financial adviser; in Equitable Life, they were not only clients of that financial institution but also its owners and hoped to benefit financially through their ownership. In Barlow Clowes, the issue was a fraud about which the regulatory authorities were in possession of sufficient information to have halted. In Equitable Life, the issues are managerial policies which were prima facie lawful in the case of differential terminal bonuses and lawful in the case of over-distribution. In Barlow Clowes, the compensation paid by the Government was 90% of their loss under £100,000, which was their capital invested; it was not the sum that the investor would have received if the fraudster's claims as to rate of return had been fulfilled. In Equitable Life, this is exactly what some policyholders are demanding. On the one hand, the policyholders are arguing that the policy values were fictitious because there were not sufficient assets behind them; on the other hand, they expect the taxpayer to fund these fictitious policy values.

Furthermore, the whole concept of loss is nebulous in relation to Equitable Life because the member is only legally entitled to the guaranteed fund value, not the policy value, before the policy is surrendered or matures.

### Parliament and Equitable Life

One of the most notable features of the Equitable debacle is the large number of MPs with past or present financial connection with that institution. The parliamentary additional voluntary contribution scheme was with the mutual. Of those lobbying for taxpayers' money, the MPs Ottaway, Lamb and Cable had past financial links with Equitable Life. I do not believe that this is a coincidence. The records of the Parliamentary debates and select committee hearings in connection with Equitable are replete with MPs declaring interests in the company...

...Parliament had good reason when it decided to grant the FSA immunity from actions in negligence. Whenever an individual loses money, he can always claim that if the regulator had done X, Y or Z he would be a richer man today. However, there is always risk when one invests. That risk is greater when ownership of the investment vehicle is involved. ELAS policyholders claim to compensation is not based upon identifying who bears the greatest responsibility for the collapse of the mutual company but is rather a brazen attempt to attach liability to the institution with the deepest pockets, the State.

### Robert Lewis

## Letter from the **National Association of Pension Funds (NAPF)** (11 May 2004)

As you will be aware the NAPF represents the interests of workplace pension arrangements in the UK. Accordingly, I am writing to you on behalf of the many hundreds of members of NAPF Member pension funds who were inadvertently caught up in the Equitable Life saga through membership of their employer's workplace pension scheme. In many cases Equitable Life was the AVC provider.

The NAPF supports calls for the Parliamentary Ombudsman Scheme to look again at complaints cases about Equitable Life, both to include regulatory bodies previously excluded (specifically the Government Actuary's Department) and to cover the period prior to the 1999-2000 period previously considered.

We look forward to hearing that you have agreed to look again at relevant cases.

**Christine Farnish**  
Chief Executive

## Letter from the **Consumers' Association** (28 May 2004)

### Investigation into collapse of Equitable Life

Thank you for the opportunity to submit Consumers' Association views on whether the Parliamentary Ombudsman should open a new investigation into the circumstances surrounding the failure of the Equitable Life.

As it has been said many time before, 'the die was cast' for Equitable Life by the time the Financial Services Authority (FSA) took over responsibility for regulating the society; the cause of the crisis is to be found in a different time. We are of the view that the primary cause of the failure can be traced back to the 1980's and 1990's and, although we did not agree with the Parliamentary Ombudsman's report of June 2003 which appeared to exonerate the FSA, (we believe that the FSA could have handled the crisis better), there was probably little that could have been done to avert the crisis by the time the FSA took over.

Consumers' Association view is that the Equitable Life crisis arose as a combination of management and regulatory failure during the 1980's and 1990's. We think that the Penrose report support's this view and contains a number of findings which point to regulatory failure on the part of the Government Actuaries Department (GAD) and lead government departments during the 1980s and 1990s, namely the DTI and HM Treasury. We believe the handling of the Equitable Life case by regulators and departments, warrants a new investigation and we would urge you to instigate one.

Whilst we think that a new investigation is justifiable in its own right, the investigation would take on a greater significance given the collapse in consumer confidence in the long-term pensions and investment industry. Consumers' Association produced a survey last year which found that fewer than half of consumers surveyed were contributing to a pension; of those who were not contributing, fewer than one in twelve said they planned to do so. When we asked why consumers weren't contributing, one of the main reasons given was lack of trust and confidence following scares such as Equitable Life.

We are firmly of the view that if confidence is to be restored, the regulatory and redress framework will not only have to protect consumers but be seen to protect consumers. A new investigation would help that confidence rebuilding process.

**Louise Hanson**  
Head of Campaigns

# Annex C

## Text of letter to Douglas Alexander MP, Minister for the Cabinet Office (19 July 2004)

### Equitable Life - the Government Actuary's Department and the Parliamentary Ombudsman's jurisdiction

As you will know, I have recently been consulting key interested parties in order to inform my decision as to whether, in the light of the Penrose report, I should conduct a further investigation into the prudential regulation of the Equitable Life Assurance Society.

That consultation exercise is now complete and I enclose a copy of the report setting out my decision - and the reasons for that decision - which I will lay before Parliament on 19 July 2004. You will see from paragraphs 19 and 20 that I have decided, subject to the addition of the Government Actuary's Department (GAD) to the list of bodies within my jurisdiction, to conduct a further investigation of the prudential regulation of Equitable Life, focusing on events relevant to the closure of Equitable Life to new business.

The administrative actions of GAD are not currently within my jurisdiction, as GAD is not listed in Schedule 2 to the Parliamentary Commissioner Act 1967.

However, there is a considerable degree of material in the Penrose report which suggests that the role of GAD was important to the prudential regulation of Equitable Life. I refer to some references in the Penrose report to the role of GAD in paragraphs 29 and 48 of my report. Other criticisms of GAD are set out in paragraph 49.

In the light of that, and based on my experience of the investigation I have already conducted, I am sympathetic to the view put to me that any further investigation by me would be meaningless without jurisdiction to investigate the actions of GAD.

You will know that the Financial Secretary to the Treasury has signalled the Government's willingness to consider any request from me for the addition of GAD to my jurisdiction. This letter is my formal request that the Government take the action necessary for this addition, and that it does so as soon as possible.

I recognise that, since April 2001, the responsibilities of GAD in relation to the regulation of life insurance companies have been transferred elsewhere. In the circumstances, if it were felt that it would be inappropriate for GAD to be within my jurisdiction in relation to its current responsibilities, then I would suggest that the relevant entry to Schedule 2 of the 1967 Act might be accompanied by a Note. This Note could limit my powers to GAD's actions prior to the date at which the Financial Services Authority assumed GAD's relevant functions.

I hope that the Government will feel able to agree to this request. I am happy to discuss this further if that would be helpful.

I am sending a copy of this letter to Ruth Kelly and to the Government Actuary. You will see also that the text of this letter is reproduced as an annex to my report.

**PARLIAMENTARY OMBUDSMAN  
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