La Levaille
33220 Caplong
France
Tel.: 05 56 71 96 47
E-mail: peter.scawen@orange.fr

Sir John Chadwick
One Essex Court
Temple
London
EC4Y 9AR

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Dear Sir John

It was a pleasure meeting you and your team on February 18th, not least as I was able to introduce Paul Chapman of Clarke Willmott and the members of the ELTA Advisory Committee, less Roy England who was committed to a prior engagement.

We all appreciated your courtesy and the constructive approach you adopted to the ideas we were presenting. We found the meeting very useful and productive, though a number of points were discussed that, in our judgement require further commentary and clarification from us.

Apportionment

On reflection we consider that, we need to develop further, the section titled *Apportionment* in the ELTA submission dated 29th January 2010, in the light of comments made at the meeting.

Sir John is required under his Terms of Reference to consider the issue of Apportionment.

> "The proportion of those losses which it would be appropriate to apportion to the public bodies investigated by the Ombudsman, as opposed to the actions of Equitable Life and other parties"

Sir John has argued that some form of apportionment to third parties may be justified and that, as a result, he may make a recommendation which would lead to some payments under the ex-gratia payment scheme being reduced accordingly. In our view, it would be appropriate to apportion the entirety of the losses found to the public bodies and therefore to make no such adjustment. Any adjustment in our view would be so highly subjective as to be considered almost arbitrary and could neither be justified nor fair.

If it is true, as has been argued, that some of the losses are due to the actions of the Auditors and Equitable Life itself, and that they should share some of the costs incurred in any ex-gratia payment scheme, it is for those entities to bear the costs, *not the victims of the maladministration*.

Our view, which is supported by precedent, has not changed: it was for the Government to regulate ELAS and hence it is for the Government to compensate. It is also our understanding that the current legal procedure and Treasury guidelines are that where more than one body may be responsible for any losses as is possibly the case with Equitable Life, the Government should be held fully accountable. Subsequently, if appropriate, it would be for the Government to attempt to recover from third parties a proportion of any payment made. In light of both that and the principles of fairness, we do not see how any apportionment can reasonably be applied to any ex-gratia payment scheme.

Auditors

In the Barlow Clowes affair, in which the Government was found guilty of maladministration and an ex gratia payment scheme set up in 1989, it is my understanding that:

> Following this, the Treasury apparently spent many years pursuing funds from auditors, those involved in the fraud, etc. Indeed, this litigation apparently only ended in May 2008. It would seem that the Treasury approved continuing litigation to recover funds as late as April 2008.
>
> The litigation was apparently most unsuccessful in financial terms, however, the Treasury Solicitor in 2000 argued that in recouping ex-gratia compensation funds "the wider public policy considerations outweigh the pure cost benefit analysis"[1].

One must conclude that it has been the Treasury's policy to attempt to recoup the costs of ex-gratia compensation schemes from those who have contributed to the events surrounding the Government's maladministration. It is a clear precedent set by the Treasury and is line with current Treasury guidelines for ex gratia compensation schemes, which are for *full compensation and recovery from third parties where possible at the choice of and cost to the Treasury.*

Whilst recognising that the Law Commission discussion paper suggests the Treasury may wish to change this approach, this has not been implemented nor has it been presented to Parliament for debate and approval.

In addition, Sir John leaves open the issue of Ernst & Young [2] where he states that –

> "I cannot reach a conclusion on the question raised in paragraph 3.20 of the First Interim Report".

This leaves policyholders in an impossible situation, as the final decision on any apportionment – which, we reiterate, we (and we believe all policyholders) would consider unjust - is based on another enquiry that is outside Sir John's control, which may or may not find for or against Ernst & Young on an issue that directly affects policyholders, but at a point where there is no prospect of either policyholders or Equitable taking any action to recover any of the losses apportioned to Ernst & Young. This reinforces the logic that any apportionment cannot be anything but arbitrary and consequently unreasonable and inappropriate.

The Society (Equitable Life)

Sir John states in IR2 7.4

> "It is one thing to say that, where the regulator has negligently allowed a regulation to be breached, there should be no apportionment against the entity

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[1] Hansard
http://www.publications.parliament.uk/pa/cm199495/cmhansrd/1995-06-20/Writtens-1.html

[2] Sir John Chadwick Second Interim Report 7.6 (ii)

> being regulated. But, in circumstances where the criticism of the regulator is made without any finding that a breach of a regulation has occurred, then serious consideration must be given to whether it would be appropriate for the public purse to make good the whole of policyholders' relative losses. In particular, if it can be said that policyholders' losses were caused in part by improvident – if not necessarily wrongful – management of Equitable Life's business, then I can see a case for reducing the extent to which those losses should be borne by the public purse."

We do not consider that it is reasonable to apply this argument in the case of Equitable Life.

It is true that the chief executive and the general management of the Society were responsible for the Society's actions, but it begs the question about what was, or should have been, the role of the prudential regulator over the period within Sir John's Terms of Reference.

If the management had made one or two errors of judgement over time that ultimately led to the collapse of the Society then it might conceivably be argued that whilst such actions fell within the remit and responsibility of the regulator to identify and correct, their infrequence and the fact that the regulator would be looking at historic events would lend merit to the argument that any such losses should at least in part be apportioned to the Society. But that is not the case.

The Society made a series of erroneous judgements over *an extended period* of time, well before, as well as during, the period covered by Sir John's Terms of Reference. Further this fact was well known to the regulators, or indeed should have been. They can hardly argue that they did not know of and understand the implications of the *With-Profits Without Mystery* paper presented to the Institute of Actuaries in 1989.

In any event, even if the With-Profits Annuitants had spotted this "imprudent management" there was nothing that they could have done as they were "trapped" contractually.

It follows therefore that it is unreasonable and unjust to arrive at 1990 and develop an Ex-Gratia Payment scheme as if the past did not exist, that the past events had not occurred and that these events had not shaped the Society of the 1990's until its closure for new business.

Arguing that the Society was responsible for its own actions does not absolve the Government from its cumulative failure to regulate. Nor does it constitute an argument that the responsibility for that failure does not correctly rest with the Government. It is the actions (or absence of them) of the prudential regulator that are under scrutiny here, not those of the Society, and it is the maladministration of the regulator for which policyholders are seeking compensation.

Isolating Accepted Loss Caused by Maladministration

In the meeting, Sir John discussed the issue of "assessing accepted loss arising from maladministration". Sir John made a distinction between "a poorly regulated company" and "a poorly managed company" with the implication that, whilst one was the responsibility of Government, the other was not.

Although **"poorly managed company"** is a very broad term and could apply to many different facets of a company's practices, we assume in this case that Sir John was referring to the financial management of the Society. Our interpretation of the distinction is that by implication, **a policyholder of the Society**, by definition a poorly managed company, was in some way "author of his own misfortune", since the client chose the Society and that the consequences of that choice relating to poor management should be excluded. Have we interpreted that distinction correctly?

It is not clear how precisely an individual can make a judgement as to whether a company is, or is not, poorly managed. The truth is that the vast majority of ordinary clients in any business sector make their decisions based on **the brand reputation** of a company. This point is clearly demonstrated by the current problems at Toyota, who for many years have enjoyed a reputation for excellence, but who in recent weeks have seen that reputation dashed by the media storm surrounding faulty components. Individuals judge a company on the basis of the perceived quality of its products and cannot judge the management save on reputation.

This was the case with Equitable Life. It would not be reasonable to expect anyone other than a professional financial adviser or actuary to delve into the financial affairs of a company like the Society and, anyway, since it was a mutual it was not therefore subject to the scrutiny that a public company would receive from corporate investors. The individual does not do so because he believes that the company's reputation is sound as a result of the fact that it is "properly regulated".

Sir John's terms of reference cite the following under section 5:

> "The Government accepts that GAD's failure
>
> (a) to ask for information in relation to the 1995 regulatory returns (namely the figure for the resilience reserve in Equitable Life's appendix valuation) which was necessary to enable it, as part of the scrutiny process, to be sure that Equitable Life had produced a valuation that was at least as strong as the minimum required by the Regulations; and
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> (b) to pursue information before it that the omitted information had led to users of the returns (specifically the credit rating agency Standard & Poor's) misconstruing Equitable Life's financial strength, constituted maladministration.
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> In relation to injustice, the Government accepts that the 1995 regulatory return might have shown a different picture of the Society's solvency position if the maladministration accepted had not occurred.
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> The extent to which the regulatory returns for 1995 would have been different if the maladministration accepted by the Government had not occurred is the subject of a request for advice from Sir John."

It would have only taken one condemnation or criticism of the Society on the part of the financial regulator to cast doubt at the very least on the probity of the company, thereby undermining the "brand image", or public perception, of the company. Specifically the reference to Standard & Poor's financial rating above is significant, because if Standard & Poor's financial rating had downgraded the Society, the financial press would have thrown the Society to the lions, all the ratings agencies would have downgraded them, forcing them to revise their strategy while there was still time (had that happened in the mid-1990's).

While it is arguable that some people would have continued to invest in the Society and had they done so they would have few grounds for complaint beyond mis-selling, it is equally arguable that many investors, particularly investors looking to make irreversible decisions with their pension pots, would either have taken their money elsewhere or would not have brought money in from other companies. Clearly, for With-Profits Annuitants, in light of the nature of the decision, the critical role of the Society's finances and the particular mechanism of the policy, it is clear that they would have not made the purchases that they did.

A further quote from Section 10 is interesting too:

> "The Government accepts that the statement made in October 2001, namely that Equitable Life remained solvent, but continued to face fundamental uncertainties following the House of Lords' judgment in Hyman, had the potential to mislead policyholders and others reading it. Greater thought should have been given to making it clear that there had been a change in the FSA's understanding of Equitable Life's state of financial health so that policyholders and others could easily understand the difference between its statement that Equitable Life met "regulatory solvency margin requirements"; (made in August 2001) and its statement that Equitable Life was "solvent"; (made in October 2001). Furthermore, the FSA should have given further thought to its statement that Equitable continued to meet its regulatory solvency requirements.
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> The Government accepts the finding of injustice, although it believes that the number of policyholders who could show reasonable reliance solely on statements made by the FSA is likely to be relatively few, if any."

Although this section refers specifically to the 2001 statements, it demonstrates that the Treasury has not taken into account the impact of either that or any earlier maladministration on the brand image of the Society, which is what would have influenced policyholders. Any FSA statement per se may not have influenced policyholders, but the ensuing loss of reputation and the commercial knock-on effects would have impacted sales to investors and shaken confidence in general.

So "accepted losses arising from maladministration" should not be restricted in the manner proposed, because the regulator's failure to act even on one occasion enabled the company to retain its blue-chip reputation, Standard & Poor's financial rating and brand image. Therefore it is arguable that all losses, or a very significant proportion of them dating back to the beginning of the 1990's, result from maladminstration. This has previously been set out in our submissions in essence, but the explicit point about reputation and brand image reinforces the point and, critically, illustrate the veracity of those earlier submissions.

When this has been discussed before, it has usually been from the perspective of individual policyholders believing that they were investing in a blue-chip organisation, etc. But if this is viewed in commercial terms, it creates a very different proposition which can be summarised quite simply as:

> "To continue to attract new business, the Society relied on its blue-chip reputation which was unlikely to be challenged while the ratings organisations

> and the financial press believed that it was properly regulated by GAD and the FSA. Any challenge by the regulator would have damaged that reputation and would have resulted in the loss of new business. The Society would have been compelled by commercial pressure to change its practices, ensure adequate reserves, or close to new business. With-Profits Annuitants' decisions to invest would have been particularly susceptible to this issue."

We can find no reference to the implications of the regulator's failure to act in the context of brand image, which can be re-stated as follows:

> "The regulator's failure to act enabled the company to retain a brand image based on an inaccurate representation of its true financial state, which in turn enabled it to attract new and existing clients to invest because they quite reasonably trusted the **'brand image'**."

Effectively, and whether intentionally or not, the prudential regulator acted NOT in the interests of the policyholders and the Government, but in the interests of the Society.

In our view, it is not feasible in this context to separate the term "poorly managed" from "poorly regulated", since it was the function of the regulator to ensure that the Society was well managed *specifically in those areas that lay outside the reasonable competence of the general public*.

The conclusion follows that the With-Profits Annuitants should be judged on the basis of a Head A approach from a date early in the 1990's and our submissions in that regard (subject to the point below) in respect of the Prudential as a comparator stand. We would also submit that the explicit references to the impact of maladministration on brand image and reputation could be considered as a "new finding of fact."

Start Date

Sir John has commented that he is restricted to evidence that is available to him in the context of the findings in the Ombudsman's report that have been accepted by the Government. This is expanded in the Terms of Reference, Assumptions and Evidence by the following bullet point:

> "Make such other findings of fact (if any) as he may think necessary in the light of the evidence contained in the publicly available reports produced to date, including the Penrose Report, the Ombudsman's Report and the Government's response to that report"

Sir John is not exclusively restricted to the period 1990 and onwards and by implication, whilst the assessment of losses may be so restricted, he is permitted to look at information prior to 1990 in order to establish an "evidence trail" when making decisions about any ex-Gratia Payment scheme.

This is particularly significant for the With-Profits Annuitants since:

a) Some With-Profits Annuities commenced in 1989 and maybe even earlier;

b) The ultimate failure of the Society was influenced by management decisions made in the 1980's; and

c) Other policyholders could, and indeed some did, mitigate their losses, an option that was not available to the With-Profits Annuitants who were trapped with the consequences of the Society's actions and maladministration of the regulators, irrespective of when their policies started.

So far as the With-Profits Annuitants are concerned, there are relatively few policyholders whose policies started before 1990 and it would seem unreasonable and unjust, irrespective of whatever start date is chosen, that those annuitants whose policies started before this self-evidently arbitrary date should be excluded from any compensation scheme.

There are two choices either:

a) Sir John devises a scheme that includes those annuitants and the financial effect of their policies from the beginning; or

b) Sir John derives their loss calculations starting with their notional policy value as of the 1990 start date.

We would comment further here that there is a practical difficulty in respect of comparators for policies that pre-date 1992 and in that regard, the appropriate comparator by default would seem inevitably to be a level annuity notwithstanding the fact that this is a non with-profits product. There seems no other real practical option in the absence of a with-profits alternative.

End date

In Sir John's Second Interim Report, he wrote:

> "4.24 Potentially, policyholders who took out WPAs may have suffered both loss of past income and the anticipated loss of future income. It seems to me that, in principle, both past and anticipated future loss of income should be taken into account in any fair payment scheme. An end date of 31 December 2007 would allow this to be done. The computation of loss would require two steps:
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> (i) First, to determine the difference between the amount the policyholder received by way of annuity payments up to 31 December 2007 and the amount that he would have received if he had invested in the comparator.
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> (ii) Second, to determine the difference between the notional value of the WPA policy as at 31 December 2007 and the notional value that the policy would have had if it had originally been invested in the comparator."

We believe that it is now accepted explicitly that all losses, past and future, offset by any gains, would be included and these should form the basis of any Ex-Gratia payment. This clarification is welcomed.

We also believe that it is accepted that a later date than 31 December 2007 is appropriate.

The issue becomes which date is set for both the calculation and the assumptions required to calculate future losses. As for assumptions, the most critical and potentially controversial elements are future bonus rate and any discount rate for future losses.

We would favour a relevant calculation date set at the latest practical moment before the submission of Sir John's recommendations with actuarial recommendations for the required assumptions as at that date. This would seem the most likely basis for the expeditious implementation of those recommendations thereafter. We would not welcome the assumptions being set by the Treasury at a later date.

The Parliamentary and Health Service Ombudsman letter of 20th August 2009

In this letter The Ombudsman asserted that absent serial maladminstration from July 1991 no reasonable investor would have joined or remained with Equitable Life.

At the meeting, Sir John invited any evidence that the assertions contained in that letter were included in the formal Parliamentary Ombudsman report.

As a result, we have had a further exchange of e-mails with Iain Ogilvie on this topic in particular seeking any guidance on this particular point. Mr Ogilvie has agreed that we may include the exchange though we restrict the content merely to his substantive response to whether the point is contained within the Report:

> "I'm in the middle of all-day interviewing this week, and so won't be able to respond in much detail in the near future, so I thought I would give you the 'short answer' now.
>
> This is that the report does not say that in terms - as it was felt that the information on which policyholders based their decisions was a marketing/conduct of business matter which lay outwith our remit and that accordingly any attempt by us to make judgements on such questions might attract legal challenge from those seeking to undermine our report. By sticking very rigidly to topics within our remit, no-one has been able to dismiss the report on the basis that it was *ultra vires*.
>
> We tried to persuade Sir John that anyone reading our report (and without the jurisdictional hurdles we faced) would form that opinion on the facts our report disclosed, but appear from what you are saying to have been unsuccessful."

It would appear that this reinforces the view that the point does not appear in those express terms within the Report. However, the comment that the overall effect of the Report matches the thrust of the Ombudsman's letter is illuminating. Of course, this accords entirely with the overall submission, which in essence, we have previously made relating to the effect of the maladministration and as set out above, this would have been particularly acute for With-Profits Annuitants. Again, we would invite Sir John to make this as a "finding of fact" particularly in respect of With-Profits Annuitants.

We hope that you have found these additional thoughts helpful.

Yours sincerely

Peter Scawen