Dr AJ Goudie
54 Dibbins Hey,
Spital,
Bebington,
Wirral,
CH63 9JX
e-mail: ajg@liverpool.ac.uk

Sir John Chadwick
The Office of Sir John Chadwick
One Essex Court
Temple, London EC4Y 9AR
info@chadwick-office.org

30/04/2010

Third Interim Report.

Dear Sir John,

Thank you for your letter of April 14th in reply to mine of March 31st. Following your suggestion that I submit comments about the various issues that arose, I now do so. I deal with the issues in the order in which they arose in your letter.

It is however I believe appropriate to preface my remarks by noting that, as I commented in my previous letter, I am well aware of the highly controversial nature of your task. I therefore hope that you will interpret my comments with this general proviso in mind.

Section 6 on Apportionment.

1. In response to my letter, as in response to a number of other policyholder advocates, you referred to section 6.4 of your report. My colleague Dr Michael Nassim has already replied to this issue in detail. I fully agree with his comments.

However, it is relevant to put on record here the difficulties that you are presumably in as a result of the status of the ongoing inquiry into the Government Actuary Department's role in the regulation of Equitable by the Accountancy and Actuarial Discipline Board (AADB).

As I'm sure you will be aware, disputes over actuarial issues occurred in the recent Judicial Review in the Administrative Court, and their Lordships noted (at 92, with my emphasis):-

[We have already referred to the table taken from the Penrose report which, at least on its face, indicates that from the early 1990s Equitable would have had serious difficulties in demonstrating its ability to meet policyholders' reasonable expectations, in accordance with its existing practices. *Even more striking, because it provides an objective expert view, is the conclusion of the Institute of Actuaries.* This related to charges brought against Mr Ranson, Equitable's Appointed Actuary at the relevant time. The panel found breaches of PRE, because of the failure to have regard to the practical implications if, in order to meet the cost of guaranteed benefits, the Society had to reduce future bonuses.”]

Thus, in their Lordships’ ruling, an extremely important expert opinion on actuarial matters was considered to be the Disciplinary Panel of the Institute of Actuaries. Given that the Accountancy and Actuarial Discipline Board has now taken over the remit of the Disciplinary Panel, it is clear that the AADB’s findings about GAD’s conduct related to Equitable may be of considerable significance in many ways, not least in terms of Apportionment. This information may now be available to you and you will have a duty to consider it. This may facilitate your thinking on Apportionment. However, it is not currently available to policyholders. Thus in my opinion it would be singularly inappropriate to make any decisions on Apportionment (or on any other issues) on the basis of such findings in the absence of policyholder input to your decision-making.

2. I simply note for the record that despite giving advice to the Government on Apportionment, you do not consider it relevant to point out to the Government that its suggested ideas on Apportionment (which, as you noted, were implicit in your Terms of Reference) differ from its *current* guidelines for ex-gratia payment schemes.

Prior Compensation resulting from Conduct of Business issues.

Again, I note for the record that you were unconvinced by my arguments about the need to consider Conduct of Business Regulation, despite my observations that:- i) There has never been a proper inquiry into Conduct of Business Regulation, and ii) Conduct of Business issues had been raised previously both by you and by the Government. I note that you give no reason for your rejection of my argument. Moreover, as my colleague Dr Nassim has pointed out to you, there is clear evidence that during a critical period in Equitable's history between 1986 and June 1991 Equitable’s Chief Executive Barry Sherlock was actually a major figure in Conduct of Business Regulation and was thus regulating himself! Given all these considerations, it would be highly improper in my opinion to apportion responsibility for policyholders’ losses to the society (as argued by the Government) as opposed to the regulators, since we simply do not know formally whether or not all policyholders were quite simply mis-sold, as I suggested previously.

Disproportionate Impact.

The thrust of my submission on Disproportionate Impact was that, due to the existence of historical overbonusing, such Impact cannot be defined at the level of classes of policyholders but only at the individual level following full quantitative analysis. Your terms of reference require you to define:-

“Factors, ... which the Government might wish to take into account when reaching a final view on determining whether disproportionate impact has been suffered.”

You argued in your letter that:-

"The Government requires me to do no more than identify factors which it might wish to consider in deciding whether disproportionate impact has been suffered by any class of policyholders."

I can see no reason why one factor that you not could readily identify for the Government in your advice is the essential role of quantitative analysis at the individual level. Moreover, I see nothing in your Terms of Reference about *classes* of policyholders as opposed to individuals. In summary, I see no reason why my conclusions about the need for quantitative analysis at the individual level do not stand.

Peer Review of your Actuarial Advice.

Again, I note for the record that you do not consider it appropriate for peer review to involve actuaries from outside the United Kingdom. I also note that you do not consider it appropriate for a policyholder advocate to be involved in the peer review process, despite the fact that such advocates have routinely been involved in previous UK With Profits controversies involving disposals of estates.

Reconstructing the Regulatory Returns.

In my previous submission to you I argued that:-

"The counterfactual reconstruction of the Regulatory Returns is flawed for four reasons. Firstly, the meetings between the regulators and Equitable which will have impacted on the Returns have not been counterfactualised. Secondly, the reconstruction ignores the critical issues of motivation and personality, particularly for the regulators involved in maladministration. Thirdly, the construction of counterfactual histories is known to lead to systematic cognitive biases which have not been explicitly eliminated in this context. Fourthly, a number of the counterfactual conclusions are either not supported by argument or prone to plausible revision".

In your reply you noted that you had no alternative but to reconstruct the Regulatory Returns within the "evidential constraints" set by your Terms of Reference. In particular, you noted that you were unable to consider the personalities and motivations of the individuals involved, an issue which I considered (as noted above), and still do consider "critical". This must surely raise the question as to whether the reconstructed Regulatory Returns are soundly based?

However, if one temporarily ignores the issues of personalities and motivations, we can thankfully counterfactually reconstruct, at least to some extent, *the content* of what *should* have happened at meetings between the regulators and Equitable, because this was spelt out very explicitly indeed in 1990 in correspondence with all Life Assurance companies (see Appendix 1).

Of course, one highly plausible reason why the issues outlined in Appendix 1 were, given the way events at Equitable ultimately unfolded, very probably not discussed in any detail may relate to the personalities and motivations of the regulators. However, reconstructing the *content* of the meetings with Equitable as they *should* have been according to official guidelines possibly resolves some of the difficulties introduced by your reluctance to consider personalities and motivations. An assumption that the regulators complied with *all* their guidelines is an implicit assumption that they were fully motivated to complete their job adequately. Thus I have highlighted in Appendix 1, and include immediately below, material which indicates that such meetings should have involved all of:-

- Determining that the Appointed Actuary was well placed to perform his or her professional duties.

- Looking at the company's plans prospectively rather than relying on the retrospective view given in the returns to the DTI.

- Considering the company's business plans over the next five years with particular reference to solvency aspects and any requirements for additional capital.

and

- The need to understand aspects which were not covered in the DTI returns.

If these meetings were explicitly designed to determine "That the Appointed Actuary was well placed to perform his or her professional duties", given the very many professional duties that Ranson was found by the Institute of Actuaries *not* to have performed, then the meetings clearly cannot have progressed as they should have. (In passing, this indicates another reason why your section 6.4 account of regulation is not applicable in the present context).

It is obviously relevant when constructing a counterfactual history of the full regulatory scrutiny of Equitable as it *should* have occurred to consider what was known by GAD/DTI about Equitable's unique business plan, which, as shown above, should have regularly been discussed with Equitable in face-to-face meetings, and should have considered prospective issues such as the development of the business plan over the next five years. Fortunately, information about what GAD knew about Equitable's unique business model is available in the Ombudsman's Chronology (see Appendix 2). This material shows that a GAD actuary (in my opinion most unsurprisingly) knew all about the unique business plan, and that he or she believed that:-

"The culture of the Equitable, as expressed in the With Profits Without Mystery Paper, did not fit easily with the new solvency margin regime introduced in 1984, a*nd it would need careful monitoring*" (my emphasis).

and that:-

"Papers like that on the Equitable would be discussed by those members of staff *with a direct interest in the company*" (my emphasis).

Thus it is very clear that GAD actuaries knew about Equitable's unique business plan, and that this business plan would require it to be carefully monitored. Moreover, we can assume quite legitimately that if the group of actuaries directly involved in the scrutiny of Equitable discussed the company's unique business model they must have *collectively* developed a group mindset which *repeatedly* prevented for *a very long period of tim*e adequate scrutiny of the company.

In her report, the Ombudsman addressed a "General Complaint", as summarised below:-

> 137 But what of the general complaint? Did the prudential regulators and GAD fail 'for considerably longer than a decade properly to exercise their regulatory functions in respect of the Equitable Life Assurance Society'?

She concluded:-

> 164 I consider that the maladministration that I have identified ***pervade****s* the exercise by the prudential regulators and GAD of their functions ***over the period covered by my investigation***. I also conclude that my findings are of such ***individual and cumulative significance*** that they demonstrate a failure by the prudential regulators and GAD to discharge their statutory functions and other obligations in a proper and effective manner.
>
> 165 But does all this substantiate the general complaint? I consider that the maladministration which I have found ***substantiates the general complaint*** that the prudential regulators and GAD failed properly to exercise their regulatory functions in respect of the Society during the period prior to its closure. (My emphases)

I personally can only conclude from this major decision by the Ombudsman that the regulatory system was fundamentally and collectively unfit for purpose over a very long period of time.

Given all these considerations, in counterfactually reconstructing what *should* have happened at meetings between GAD/DTI and Equitable, I find it impossible not to believe that *all* of the issues detailed in the four bullet points above should not have been regularly discussed. Importantly, such scrutiny was explicitly designed not only to protect current policyholders but also to protect *future* policyholders, as evidenced by the fact that scrutiny involved monitoring "the company's business plans over the next five years with particular reference to solvency aspects and any requirements for additional capital."

It appears likely to me that the counterfactual reconstruction of the history of Equitable's regulatory scrutiny may be impacted considerably by the findings of the Accountancy and Actuarial Discipline Board. I note that in its submission to you the Treasury reproduced in full the Institute of Actuaries Disciplinary Board's findings about the very many professional failures of Equitable's Appointed Actuaries. It therefore seems potentially highly inequitable that policyholder advocates are not to be allowed to use possible analogous findings by AADB on the professional failures of GAD/DTI in order to reconstruct the full regulatory process as it should have occurred.

I note that you made no comment on my third point (see above) about the systematic cognitive biases that occur when developing counterfactual histories.

In summary, I suggest that for various different reasons the counterfactual reconstruction of the Regulatory Returns outlined in Interim Report 3 is prone to serious challenge on the grounds that it is not soundly based. Moreover, given that the regulatory regime involved understanding issues which were not covered in the DTI returns, as well as prospective analysis of a life assurance company's future, the reconstruction of the Regulatory Returns in Interim Report 3 lacks highly salient information.

You may consider it essential, given your Government derived Terms of Reference, that you are required to counterfactually reconstruct the Regulatory Returns as the Government recommended in its submission to you. However, if this approach is irrational, lacks intellectual coherence and results in what could be called a “solemn nonsense”, it must surely be discarded and be replaced by an intellectually coherent procedure for determining the causation of policyholder's losses?

I do not consider it at all implausible that, if the whole regulatory *process* (as opposed to the limited Regulatory Returns) was counterfactually reconstructed as it should have occurred, the final result might not have been very different, such as involving the early closure of Equitable, as I understand from Dr Michael Nassim you are now considering.

I repeat that I am aware of the highly controversial nature of your task. Moreover, I am also aware that the controversial nature of this task is entirely of the Government’s making. Nevertheless, I hope that these comments will be of value to you in developing your advice for Government.

Given that time is pressing, as you indicated in your letter to me, I will take the liberty of putting this letter into the public domain as I did with my previous letter, a process which you indicated was acceptable to you.

Yours sincerely,

Dr A J Goudie.

Acknowledgements:- Although this is a personal submission, I am deeply indebted to my policyholder collaborators:- Dr Michael Nassim, Nicholas Oglethorpe and Michael Josephs.

<u>Appendix 1.</u>

The Ombudsman's Report. Part Two Page 85. (Author's emphases)

Programme of visits to appointed actuaries

404 On 7 November 1990 the Government Actuary wrote to appointed actuaries to inform them that officials from the DTI and GAD were beginning a rolling programme of visits to life insurance companies, intended to cover all authorised life insurance companies in the UK over a three year period. The letter stated that the aims of the visits were:-

(a) to strengthen the appointed actuary system by achieving closer contacts between appointed actuaries and senior officials of GAD and the DTI, explaining that GAD wished to be satisfied that the role of the appointed actuary was well understood within the company and that ***the appointed actuary was well placed to perform his or her professional duties****;*

and

(b) to improve the supervisory process ***by looking at the company's plans prospectively rather than relying on the retrospective view given in the returns to the DTI*** made under the ICAS Regulations 1983, indicating that officials would wish to discuss with appointed actuaries and senior management ***the company's business plans over the next five years with particular reference to solvency aspects and any requirements for additional capital***.

405 Although discussion at the meetings was mainly to be about actuarial matters, it was indicated that wider issues would be discussed. The letter explained that in order to maintain effective supervision ***it was becoming increasingly necessary to understand aspects which were not covered in the DTI returns***, for example any group corporate structure, any service agreements between the insurance company and any other companies in a group and the sources of the company's business. It was suggested that it would be necessary for the company's senior management, including its chief executive, to be present for at least part of the visit, particularly when ***business plans*** and group structure were to be discussed. (The DTI wrote simultaneously to the chief executives of insurance companies enclosing a copy of this letter.)

<u>Appendix 2.</u>

The Ombudsman's Report. Part Three. Pages 19-20 (Author's emphases)

20/03/1989

In his witness statement to the Penrose Inquiry (provided in May 2003), Directing Actuary A stated:-

I read "With Profits Without Mystery" and attended the debate at the Institute of Actuaries just before being promoted to Directing Actuary [in April 1989]. (By way of background, I should explain that Institute papers were distributed to members about two to three weeks before they were presented for discussion. After an initial brief introduction by the President, a previously appointed "opener" would give his views on the paper, and this would be followed by other members of the profession who wished to speak. There would also be an official "closer" of the discussion. ***GAD did not hold a formal discussion of Institute papers amongst themselves, but papers like that on the Equitable would be discussed by those members of staff with a direct interest in the company***.) The Equitable was generally seen as being a special company due to its historical significance as the first life insurance company, and the fact that actuarial thinking basically started with William Morgan, its first actuary. ***Nevertheless, I concluded that the culture of the Equitable, as expressed in the Paper, did not fit easily with the new solvency margin regime introduced in 1984, and it would need careful monitoring*****.** While I sympathised with the philosophy that the current generation of policyholders owned the company (being a mutual), nevertheless the fact that the Equitable's culture also meant that policyholders would receive a reasonable approximation to the value they had built
up in the company on the maturity of their policies, thereby inhibiting the building up of an estate, meant that the solvency margin (or at least the explicit component of the solvency margin) would need to be met largely from the investment reserve held back to fund terminal bonuses.

He continued:-

With other mutuals, an estate had normally been built up by past under-distributions of bonuses to policyholders, whether deliberately or otherwise – for example, in the latter case through perhaps not having some kind of asset share technique – while in a proprietary company the solvency margin could also be covered by shareholders' funds, and in extremis through calls for increased levels of shareholder capital, although raising this has its own difficulties. The irony was that those companies which had underdistributed to policyholders and shareholders in the past were most able to meet the new solvency margin requirements. ***I did not participate in the debate as I felt, as a regulator, it would not be appropriate to discuss the affairs of an individual company in public.***

I could envisage that, in the event of a deep, sustained fall in the stock market, the "With Profits Without Mystery" culture, in relation to bonus declarations, might need to change, much more quickly than for other companies with an estate, if the company were to maintain its required solvency margin.