Michael Josephs
4 Elm Gardens
East Finchley
LONDON, N2 0TF
+972 547 82 9191(mobile)
+Email: mikeruti@netvision.net.il
10 June 2010

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

Dear Sir John,

Diagnosis, Remedy and Redress

Much to the general surprise, given your previous undertaking to provide a "Final Report" before the end of May, you circulated further papers on 25 May and asked for comments by 12th June. My own prior perception was that both the structure and the thinking of your work for the Treasury were deeply flawed, and the new documentation simply reinforced that assessment. I find, after raising the issue with other knowledgeable campaigners, that this is the broad consensus.

In my letter to you of 24th March in response to IR3, I listed eight fundamental weaknesses in your approach as follows:

- **i.** **The treatment of the PO's findings as being individual and separate, rather than as indicative of the general failure of the regulatory system over at least a decade.**

- **ii.** **The disregard of the responsibility of the Secretary of State for all the *regulatory* activities of the Appointed Actuary (Ranson), in favour of the implication that because the Society paid him, it was responsible for any errors that he made.**

- **iii.** **The lack of any attempt to establish the basic *causation*, either of policyholders' losses, or of the failure of the regulators to use their powers to mitigate those losses.**

- **iv.** **The general lack of reliable quantitative information that should inform any study such as this one.**

- **v.** **The assertion, contradicted by internal evidence, that Towers Watson have some special expertise in counterfactual reconstruction of 'what might have happened'.**

vi. The almost total disregard of the findings of the Disciplinary Tribunal which laid down mandatory standards of professional behaviour in relation to Equitable's 'unique business platform', especially in connection with disclosure of realistic liabilities.

vii. The conflict between your supposed 'independence' and your adherence in practice to the exact Terms of Reference prescribed by the Treasury.

viii. Your tolerance of the Treasury's habit of drawing on matters outside the scope of the PO's investigation, while denying the same latitude to policyholders.

As far as I can see, none of these weaknesses has been addressed in the new material that you have circulated and some have even been exacerbated. Indeed, the revised scenario presented in Towers Watson's accompanying letter is based on the thesis that the dysfunctional operation of the regulatory system in relation to Equitable Life was so deeply ingrained, and the deference to the professional influence of Messrs Sherlock and Ranson so absolute that the regulators were in effect, incorrigible. They would never require anything more than the most minimal changes to the Regulatory Returns and they would only deploy their statutory powers to force proper disclosure and to protect the interests of new and existing investors to the minimum extent.

Since this has been the implicit stance taken by The Treasury for the last ten years we must expect that they will find the new scenario acceptable, even though it completely invalidates the scenarios so confidently advanced in IR3 (which made no mention of policyholders' rights or realistic deficits). It also emphasises the dangers of allowing such scenarios to be drawn up by a group of actuaries who have a vested interest in defending the advice that they individually gave (and the decisions that they took) over the years in question. Dr Nassim was remarkably prescient in warning you of just these dangers nearly a year ago.

I regard the work of your actuarial panel as shoddy and unconvincing, because they have fallen into the trap of believing that they are able now in 2010 to identify <u>a single alternative past that would have emerged in 1991 had the Regulators been minded to do their proper job.</u> Their intellectual contortions to arrive at conclusions acceptable to the Treasury would be comical were it not for the dire implications for policyholders. Had they bothered to involve policyholder advocates in their rarefied debates, they would have had to think about a number of more radical and more divergent scenarios which are at least equally credible, and which do not support the Treasury's position at all. For example, my note to you of 27th April described a credible scenario of full closure by the end of <u>1991</u>.

Equally damaging to the credibility and the utility of your work are the major gaps in causation which you have declined to address, although they are fundamental to any understanding of policyholders' losses and the extent to which the Public Bodies were responsible for those losses. Coupled with these

black holes in the official narrative are the crucial gaps in quantitative data, including a dearth of reliable data from 1982 to 1994 which was the period when the primary losses were generated. I have already raised the issue of lack of data with you on several occasions.

These criticisms are not arbitrary, nor are they perfectionist nitpicking. Rather, they go to the root of the case for redress, and the debate over the use of public funds, i.e. taxation, to pay that redress to such policyholders as may be entitled to it.

It is my contention that a major failure in public services that has cost the victims anything between £5 Billion and £10 Billion, and which ought to lead to redress payments of a similar order, must be properly explained both to Parliament and to taxpayers. This is impossible without filling in the causation gaps, which can be summarised as follows:

a. **Why do we not know what the management of Equitable did that resulted in the crystallisation of such large losses in 2001 and thereafter?**
b. **Why do we not know why the regulatory system consistently failed during the 1990s (and earlier) to deal with the unacceptably high risks to new and existing policyholders arising from running with a 'negative estate'?**
c. **Why were the Public Bodies, led by the Treasury, so antagonistic to policyholders post the 2000 closure that they denied them any access to compensation (except that from their own fund)?**

There is a substantial danger that, absent proper explanations of at least the first two causative elements, no reasonable scheme of redress will be approved: Parliament and Public will be left doubtful and confused, and either only token payments will be made or the proposals will be 'sent back' for further investigation and delay. This is of course the almost inevitable consequence of the Treasury's long term strategy of denial and concealment of data.

In each case we need to resolve three key aspects:

1. **<u>Diagnosis:</u> what were the fundamental elements of the failure, and how did they in turn benefit or harm the claimants?**
2. **<u>Remedy:</u> the minimal changes required in the attitudes and the actions of those responsible in order to avoid foreseeable harm to investors.**
3. **<u>Redress (gross liability for):</u> a methodical estimate of the financial impact *on each individual investor* of the Remedy Scenario as compared with the actual history, carried forward to the projected conclusion of every contract.**

Each aspect presents real problems, as we all well know. But those problems cannot be resolved by looking the other way while whispering "..not in front of the children".

The primary problem with *Diagnosis* is that there have been twenty or more years of denial, misdirection, and obfuscation to protect those responsible from the consequences of their own actions (or lack of action). For example it is still being claimed that Equitable failed because of the lack of provision for GARs, whereas we know that there were already massive realistic asset shortfalls in 1990, long before any GAR provision was deemed necessary.

***Remedy* poses some genuine intellectual challenges as TW have amply demonstrated by their failure to come to grips with it in the case of the regulators. Rarely will there be just one remedy and often there will be many possible candidates, the practicality and cost of which will vary considerably. The one thing that we can say is that all the much lauded organisational changes that were invoked when the GAD and DTI Regulators became part of the FSA were remarkably unproductive as the behaviour of the FSA towards ELAS policyholders was worse than that of its predecessors!**

***Redress* is the area which demands good data at the individual level, and this is exemplified in the American approach to defaults by financial providers. Under their system individual accounts would have been reconstructed back to 1982 at the latest, even if this meant recovering old computer data or working from printed records. This would have started as soon as the PO presented her Report to Parliament and reliable detailed information would have been available a year ago. My point is that without such information it is almost impossible to advise Ministers and Parliament of the true scale of potential claims and payments.**

I have laboured my exposition of these issues because I believe them to be so fundamentally important to the general case for paying redress. It is instructive to compare a hypothetical Ministerial Statement under present knowledge (A) with one where the 'black holes' have been filled in (B). The additional narrative is shown in blue using a lighter typeface.

A. *With causation undefined:*

"The Government is bringing this scheme of redress forward for Parliament's approval. Equitable Life was mismanaged in unspecified technical ways from the late 1980s, although without necessarily breaching any rules. The consequences of this mismanagement became more and more visible to the regulators from the end of 1990, but they adopted a passive approach in the expectation that matters would improve. This expectation proved to be unfounded and Equitable was hit be further problems relating to guarantees in policies dating back to the 1970s. The scheme of redress seeks to make good a fair portion of the damage inflicted by the Regulators' passivity, but does not seek to compensate policyholders for losses outside regulatory control. Parliament is asked to approve the basis of payments as set out in the Command Paper and a total related expenditure of £X.Y Billions."

* * * * * * * * * * *

B. ***With causation defined for both managerial and regulatory failures:***

"The Government is bringing this scheme of redress forward for Parliament's approval. Equitable Life was mismanaged in from approximately 1984 onwards when its actuarial management decided that they could award unguaranteed bonuses in excess of available assets without the over-allocation being visible in their Accounts or Insurance Returns. Essentially they were 'gaming the system' to give the appearance of a superior track record, because unlike most of their competitors they no longer maintained a Free Estate of unencumbered assets. It is debateable whether what they did was in breach of their fiduciary duties, and that question is unlikely ever to be resolved. Their Insurance Returns continued to meet the statutory requirements, but only marginally. The effects of this overbonusing became more and more visible to the regulators from the end of 1988, and there were various matters that should have provoked intensive enquiries of Equitable Life (but did not do so).

However, and with regret, I must now admit that the regulatory culture of that era had developed a strong bias towards protecting the Life Assurance Industry and the Actuarial Profession at the expense of policyholders in general. This was routinely justified by the need "..to maintain confidence in the Industry". I hasten to say that there is no evidence of any corruption or improper inducements, and we believe that it was more a case of having too many shared interests. As a result of this bias **the regulators adopted a passive approach in the hope that matters would improve. This hope proved to be unfounded and Equitable was hit be further problems relating to guarantees in policies dating back to the 1970s** which the regulators actively concealed both from the public and from Equitable's non-executive directors. There has been a careful and fair assessment of how capable regulators should have behaved, even in a political environment unfriendly to regulation, and we now accept that while the regulators could not reasonably have prevented any losses caused by the actions of the Society before 1989, they could have prevented half the losses caused during 1989, 1990 and 1991, and all of the losses caused from 1992 onwards, when in our opinion the Society should have been put into run-off.

The Government has drawn some belated lessons from these much delayed findings. The first lesson is that it must be made far more difficult for any insurance or pensions organisation to adopt dangerous practices or to operate with inadequate reserves just because their actions fall within legalistic statutory limits. The second lesson is that every Government Regulator must undergo a periodic inspection by genuinely independent experts in order to ensure, as far as reasonably possible, that regulation remains 'fit for purpose' and that regulators remain aware of their primary remits, and are not 'captured' by those they are put in post to regulate. Measures have already been taken, in conjunction with our European partners, to implement both of these lessons.

The scheme of redress seeks to make good a fair portion of the damage inflicted by the Regulators' passivity, but does not seek to compensate policyholders for losses outside regulatory control. Parliament is asked to approve the basis of payments as set out in the Command Paper and a total related expenditure of £X.Y Billions."

* * * * * * * * * * *

The crucial difference between the two statements, illustrated by the material in blue, is that the Minister is able to give concrete explanations of what went wrong supported by proper investigative findings. I have perforce chosen explanations that fit the facts as we know them, but I am not asserting that these explanations are correct, even if they do provide a plausible template for reconstructing what actually went wrong.

The point which must be emphasised is that the explanations in question provide a proper rationale for calculating individual losses in an objective way, for identifying the extent to which regulators should have taken action that would have mitigated those individual losses, and lastly deciding how much of that 'regulatory loss' should be redressed from Public Funds.

But this is not what your own advisory group has been doing. Instead of remaining open minded and "even-handed" as you initially assured us, it has rigidly adhered to assumptions written into its Terms of Reference by the Treasury which relate not to facts but to the longstanding prejudices of previous Administrations, and which are both illogical and self-serving.

Nevertheless, the results of your work will surely please the politicians who commissioned it, and who displayed unflinching animosity to policyholders' reasonable claims. I sincerely doubt that the new Administration will see them in the same light.

Yours sincerely

Michael Josephs