Liz Kwantes

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Subject: Round 2: Sir John Chadwick IR3 urgent response follow up- final.

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April 7th 2010.

Advance copy by e-mail.

Dear Sirs,

Thank you for Laurence Emmett's brief letter of reply on March 19th [1] to mine of the 12th [2], and more lately his of March 29th [3].

When I wrote urgently to you I did not know that Equitable Members Action Group (EMAG) was about to pull out of your process, and indeed then hoped that such an eventuality might be prevented. One can only hope that EMAG provided you with a politely articulate criticism of your Third Interim Report [4] in support of its disengagement, such that we may all enjoy its more constructive comments when your next round of correspondence is published. *If EMAG did not do this in any detail, then by copy of this letter let me express the hope that it might do so now for all our sakes, such that its thinking may receive due consideration in your Final Report.*

Given EMAG's disengagement and the emergent resolve of everyone else to help make your Final Report as fit as possible for any future purpose, irrespectively of whether that now takes place in the UK or the EU, the immediate need for urgency has passed. On that understanding, and having received no further guidance from you until Mr Emmett's further letter of March 29th, I had already taken up his earlier invitation to follow up the more urgent concerns and finish the job. Therefore if in avoidance of substantial re-working and repetition some of the March 29th letter [3] has been answered rather indirectly, let me apologise in advance. Whatever, the current task is to do ones utmost to help you satisfy the requirements of Equitable policyholders and Parliaments various, and to long stop the situation in the event that you do not. Inevitably it requires some further consideration of pivotal regulatory failure in the late1980s, and of the Parliamentary Ombudsman's (PO's) evidential base as well as her official findings [5] in relation to those of the European Parliament Temporary Committee of Inquiry into Equitable Life (EQUI) [6]. It also requires some further exploration of the basis for the counterfactual thinking in your proposed high and low impact scenarios. That in turn helps to inform the approach to your proposed Head A and B comparators and their impact on present loss or that going forward. And since your advisors have yet to

acknowledge the need for genuinely un-hypothecated free assets in with-profits assurance business other than an indiscriminately minimal finance pool which you have termed a 'rolling estate', it may be helpful to turn the coin and explore the implications of asset deficiencies rather than surpluses for established and future loss. Without this Mr Wiscarson cannot help you address the future predicament of the Society's remaining policyholders, nor might a similar reconsideration of the future for with-profits annuitants transferred to the Prudential be made should Peter Scawen's idea of a one-off payment for them not be practicable. That done, any loose ends can be tidied away.

It is now clear that your correspondents mainly regard the Third Interim Report (IR3) [4] as a retrograde step, which has disrupted a process which should otherwise by now be well into its convergent phase. As a result there is far more unresolved and divergent opinion than there should be, which bodes ill for the next stage. And yet, when your entire process is reviewed (as I now fear it may be), this will be found to be because the Treasury and your advisors have advanced pretty much the whole gamut of official myths which together fortify the UK position of defensive vested interest. Your record duly shows how much time and effort has been required to explode this all over again. Indeed that part of the process is not fully over. Despite this, you now have a great range of collected thought and even wisdom at your command, and so may you now choose equally wisely and well from it in repairing the position. In that spirit let me also attempt to fill what I perceive to be the more important gaps. Should such a piecemeal approach create difficulties of continuity let me apologise for them in advance, and say that each paragraph has not only a number but a title, such that the finding and ordering of material can be made to suit personal preferences. If still it all seems too much, then there are a final summary and conclusions which may be read first. As is my custom the most important conclusions are *italicised.*

1. **Further background:**

1.1 Proceeding from the general to the particular, we have previously seen how the Treasury has used the Penrose Report [7] to make assertions about policyholder's knowledge of ELAS's practice, and that such practice could be classified as routine business decisions [8], with the necessary supporting inference that such practice had been communicated accurately to policyholders.

1.2 If accepted this would have permitted a "minimal change" approach to the Society's essential character no matter whether or not there might have been maladministration at any time. We have also seen how the simplistic mantra that the Society was the author of its own misfortunes has been used in an attempt to apply the principle of joint and several liability to all generations of its rank and file members in apportioning loss (MN March 12th letter Appendix I) [2] . But before proceeding further it is first necessary to set all this against the traditional platform of redress provided by the Financial Ombudsman Service (FOS).

2. **The Penrose Report as a one edged sword.**

2.1 The original FOS approach to compensation was based on the mythical assumption that the Guaranteed Annuity Rate (GAR) was the only problem to Society faced, and hence that, with the advent of the Compromise, any mis-selling claims related to the GAR had been settled thereby. Hence such claims did not qualify for compensation. Moreover, the criteria for what constituted a "GAR-related" claim were widely inclusive, which had the effect of reducing potentially eligible claims even further. Following publication of the Penrose Report, on March 22nd 2005 the Chief Financial Ombudsman also decided that any claims based on its evidence should be classified as "Penrose-related", and disallowed [9]. Thereafter, if any claims criteria based on Lord Penrose's findings were to be met, irrespective of whether or not they were subject to the Statute of Limitations, they could be established only through the Courts. The practical effect of this was that most ordinary policyholders could not use Lord Penrose's findings as a means for

furthering their claims.

2.2 Now, however, the Government has said that you may take Penrose as read. *Hence it is well beyond ironic that Penrose is being used against the very persons who earlier were denied it in support for their own claims for compensation.* Nor need we re-explain why what constitutes fact or findings in Penrose has also to say the least been given a very liberal interpretation. One might therefore forgive those policyholders who think they have now been squeezed between two Penrose rocks and a GAR hard place. *Since policyholders additionally know from the PO's Chronology how the FOS's GAR and Compromise stance was brokered by the prudential regulators [10], the situation has become doubly objectionable.* I have previously analysed that stance in more detail [11].

2.3 More generally, therefore, the FOS position has both argumental and causal links with the dual standards approach to Penrose employed by the Treasury. The consequences of the latter are explored in more detail below. *More immediately it is clear that many deserving policyholders have either been denied compensation or undercompensated by the FOS, such that the FOS criteria for determining relative loss may have to be set against whatever relative loss criteria you eventually adopt.* If not, there is the risk that unconsidered and un-reconciled relative loss awards might cause yet further inconsistencies- even injustice. Hence one reasonably hopes that any such reconciliation will be done transparently. *I have very recently and at long last received an Ombudsman Final Decision in respect of my annuity, and so if you need any further illustration of the tortuous process involved, or of the outstanding problems with rescissionary bases in respect of both past and future loss, then I can provide it for you.*

2.4 Before quitting this area please allow me to refer you to the considerations in Section 13, because as therein explained the conformity of the FOS position, overall Compromise stance and Reinsurance Treaty matters may in the future need more searching re-examination.

3. More on the pivotal failure of regulation in the late 1980s.

3.1 In my March 12th letter [2] it was explained why the essentially amoral 1987 "routine business decision" to continue the false promise of an unbroken bonus series under conditions of inequitable over-distribution compounded by unadvertised inequalities of guarantee and consequent liability was so fundamentally objectionable that it could only have been imposed by stealth, selective partial disclosure and misrepresentation. You have now established this independently with regard to smoothing, or when finding that the policy of estateless "full and fair" distribution played a minimal and misrepresented role in communications with policyholders [12, 13]. Inevitably this also means that mis-selling must have been widespread, although that is of only peripheral interest to you. More pertinently, however, 1987 also saw the publication of Institute of Actuaries (IA) President Marshall Field's Presidential address "Risk and Expectation" [14], in which he so rightly said: *"The new regime puts great weight on the concept of disclosure- what can be described is defensible and what cannot is suspect."* Hence, irrespective of whether the original "routine business" decision, its misrepresentation or both were fraudulent, there must have been a pivotally catastrophic failure in both Prudential and Conduct of Business regulation. But before proceeding to see why in retrospect that is so very hard to justify, let us revisit what the Treasury actually submitted to you:

34 "In the case of Equitable Life the regulator was not responsible for the policy of full distribution adopted by the Society, nor for the quality of the decisions made by the Board, nor for the quality of the advice received by the Board. The Parliamentary Ombudsman herself states that the maladministration she found played only a contributory role to policy rate cuts which took place in July 2001 and that *" ... the external context and matters unrelated* to *the acts and omissions of the prudential regulators and/or GAD did have* a *direct impact on the creation of the situation ..."* Further she goes on to state that regulatory failure was only *" ... part of the reasons why the Societies options were limited ..."* (Emphasis added - see Part 1, Chapter 12 para 183 of the Ombudsman's Report) thus acknowledging that other factors caused the difficulties in which Equitable life found

itself and that the maladministration identified was only one of the causes of loss. The Ombudsman made a finding that " ... *losses associated with the July 2001 policy value cuts* are *not exclusively attributable* to *maladministration which I have found* to *have occurred but that such maladministration was one among many contributory factors* to *those losses."* (see Part 1, Chapter 12 para 183 of the Ombudsman's Report). This, in turn, chimes with the comments by Lord Penrose that regulatory system failures were a secondary factor in Equitable's misfortunes (see The Penrose Report, chapter 20, paragraph 84, page 745.)"

35."The Ombudsman's report was concerned solely with the acts of the regulatory authorities, as she herself repeatedly acknowledged. It did not purport to deal with the acts or responsibilities of other participants. In acknowledging this the Ombudsman quoted from the submissions made to her on behalf of the public bodies that any reader of her report should not be left with" ... *the incorrect impression that* it *was only, or even mainly, the prudential regulator who bore responsibility for Equitable's subsequent difficulties."* (see Foreword, page ix.) In fact, however, many others were involved in and responsible for running Equitable."

36."Primary responsibility for policyholders' funds rests with the insurance company. It takes decisions about the investment of those funds, how much to declare by way of bonus and the maintenance of assets. It was Equitable's decision to have a policy of full distribution and not to maintain an estate. It decided to introduce GARs and to include GAR and non-GAR policies in the same fund. These were commercial judgements. If the management of Equitable made improvident or unwise decisions which led to loss, this is a matter which is attributable to Equitable as a company and in no sense to the regulator. The extent of the regulator's contribution to loss should reflect the fact that it has no role in relation to these commercial decisions."

3.2 For convenience the Treasury's central assertion in paragraph 36 has been underlined. Michael Josephs has commented to me thus; "*It is my contention that the arguments presented by the Treasury in 34,35,36 are casuistic in the extreme: they have no basis in UK statute or in EU Law, but they are in fact a truthful representation of the way the Regulatory system behaved in the case of ELAS …"*. I am satisfied that he has illustrated that in some sense the Treasury's argument is circular, even to being a tautology. The roundelay processes in this general way: =Regulation="Light Touch" Regulation=No regulation=No Duties=No responsibilities=No liabilities=. With all this in mind, let us examine precisely why this position is so objectionably pernicious by looking at just how much the regulators had to turn their blind eye to.

3.2.1 Firstly, the inflationary climate of the 1970s and 80s was drawing to a close, and former levels of GAR looked to become valuable. Hence, as Christopher Headdon has stated [7: 2.61], the notion of a differential terminal bonus was an Equitable Life Assurance Society (ELAS) senior management reserve policy from as early as 1983, which not merely coincidentally is roundabout when the Society's entire estate had been dissipated. That fact alone undermined some of the explicit assumptions that With Profits Without Mystery (WPWM) [15] said it respected. A notable example is the WPWM 3.2.6 Ranson-Headdon assertion that if an office's custom is to pay total benefits in full, the guaranteed portion is of little importance. (Indeed, as we have previously seen, that idea is still reverberated by the likes of IA President Nick Dumbreck.)

3.2.2 Secondly, at the end of 1986 IA President Marshall Field issued a general warning on the consequences of the change in climate in the new "freedom with disclosure" era in conjunction with a perceived shift of with-profits business from assurance to investment contracts, and at a time when interest rates were falling [Presidential Address later published as 14].

3.2.3 Thirdly, as recorded in Penrose [7] the regulatory aspects of this were picked up and addressed by George Newton of The Government Actuary's Department's (GAD's) Insurance Directorate in 1988. Because of the Newton memorandum's comprehensive import it was drawn to the attention of the PO Investigation team head in a letter dated June 30th 2005 [16], which was subsequently published at EQUI [18]. A duly prefaced version of Lord Penrose's abridgement of Newton was later submitted to the PO's investigation as part of a critique of the PO2

process and content at the end of the draft reporting stage, and again in the Final Report critique [10]. For your convenience it has been reproduced for the third time as Appendix I.

3.2.4 Fourthly, when WPWM was presented successively to the IA and Faculty of Actuaries (FA) in 1989/90 [15], the actuarial discussants picked up on all the potential problems inherent in the underlying so-called "routine business decision" on which WPWM later turned out to have been based. What is more, they highlighted the consequent duties of information arising in the "freedom with disclosure" era. It will be found that discussants repeatedly emphasised the following:

- Adequacy and continuity of estate or reserves, to meet the needs of both present and future policies.
- The relative size of terminal and reversionary bonuses in policies, and the need to reserve for them.
- Potentially excessive mutual insurance arising from a pooled unitised fund in which the interests of policies of different lengths and levels of guarantee are indiscriminately placed.
- Given that the investment profile of a pooled unitised fund cannot be ideal for all policy types and durations, an additional mismatching reserve must be held.
- There is a consequent need to explain the potential inequity and risk this poses to policyholders and their advisers.
- Conversely, there is a need to explain the relevance of the guarantees, and how they will be met and charged for.
- Concerns about financial strength under all circumstances, given that the unconsolidated bonus element is used to take up new business strain while continuing to be paid out in full in the absence of an estate.
- The resulting duties of information.

3.2.5 For your convenience, and because Lord Penrose in the event made no analysis of his own, I have re-visited an earlier account of it all [18]. It demonstrates that the discussants did indeed cover all the problems. This forms Appendix II.

3.2.6 Fifthly, despite this by then the die was cast, and Ranson and Headdon had no option but to ignore it all- as you and we all now know full well they did over many years. *One has no option but to repeat that neglect of such expertly authoritative and strongly prescriptive peer review can only have been both conscious and deceitful.*

3.2.7 Sixthly, the regulators proceeded to ignore it all too, despite having had the additional benefit of being able to read the runes in the Society's returns, or in literature for members present and prospective.

3.2.8 Seventhly and finally, 1990 was a difficult one for the Society, and its bonus declaration has been criticised for being inappropriately high. So how did the GAD, with the Field and Newton caveats in mind and WPWM twice published and finally discussed that very year, permit this overall situation to continue? It all beggars belief, and in retrospect is extremely difficult to justify.

4. Studied indifference to Newton's caveat.

4.1 Despite the process of entreaty mentioned in 3.2.3 the PO made no reference whatsoever to the Newton memorandum in her Report [5]. She did, however, allude to Field. But since George Newton's memorandum was originally abridged and quoted in Penrose it is evidence admissible to you. That is the main reason why it is now brought forward yet again for your careful consideration in Appendix I.

4.2 Newton's relevance to the current situation is self explanatory. *From the regulatory perspective it is one of the essential bridges back to a flexibly fair approach to overall loss, rather than a narrowly incomplete, rigidly restricted, truncated and report-based*

prudential one. It is also an appropriately unifying framework within which to view the broad continuum of all the important causal regulatory events occurring before, during and after the PO's reference period.

4.3 In that it so clearly anticipates the EU Third Life Directive it is also a bridge to the reciprocity of rights of policyholders in all jurisdictions (*vide infra*), and the findings of EQUI [6] in relation to the overarching aims of the EU Life Directives which those jurisdictions will now expect to be honoured. Quite simply Newton's rightful place in the evidential record can be ignored no longer.

5. **EMAG's perspective on pivotal regulatory failure prior to the PO's reference period:**

5.1 Page 42 of the EMAG response to IR2 [19] by Burgess Hodgson contains a rather more blunt account of this area of concern, which may also be set against Treasury paragraphs 34,35 and 36 above:

5.2 *"In this context we make one final point. The regulators should have been aware of Section 458 of the Companies Act 1985. This made it a criminal offence to carry on a business with intent to defraud the creditors. Policyholders are creditors for this purpose.*

5.3 *Non-GAR policies had been sold since 1988, and were continuing to be sold, without disclosure of the fact that a substantial group of pre-existing GAR policies exposed the Society's common with-profits fund to a guarantee against the risk of interest rates falling below about 8% p.a. Interest rates had been falling since 1982 and by 1995/6 had fallen below the critical rate and the option against the Society was 'in the money'. Non-GAR savers were taking on a big risk, but they did not themselves benefit from the cover. They were not informed of the nature of the risk or the fact that it applied to a large proportion of the fund or the fact that the Society had made no provision to meet it.*

5.4 *It should have been apparent to the regulators that the Society's business was being carried on dishonestly. The regulators should have been concerned that the Equitable had little defence to a claim that it was being run with intent to defraud its non-GAR policyholders.*

5.5 *Even if they concluded that no criminal intent could be substantiated, the prudential regulators should, at the very least, have drawn the matter to the urgent attention of conduct of business colleagues and considered whether adequate provision had been made for mis-selling costs."*

5.6 Though Burgess Hodgson and EMAG's long awaited change of stance on the issue of fraudulent misrepresentation is a most welcome clarification, you will see from Appendix II that on March 20th 1989 WPWM discussant Mr H.W. Froggatt had anticipated all this, and drawn Mr Ranson's attention specifically to it. But like you Lord Penrose had a limited brief, which in his case precluded him from apportioning any blame. One might deduce that this is why in the end he avoided any detailed discussion of WPWM. *Just as well, therefore, that such a discussion had been prepared beforehand and an appropriate position reserved in respect of it [18].*

5.7 Sadly, and of more immediate concern, the regulators did not act on this either, *and when the question of mis-selling came up again within the PO's reference period her chronological record duly shows the lengths to which the prudential regulators went to suppress and turn the Personal Investment Authority's (PIA's) mis-selling report and neutralise Nicholas Warren's legal opinion on the subject [5].* As you already know EMAG director Alex Henney [20] and I [10] have previously covered the details of all this. Its current importance to you is explained further in 13.3 below.

5.8 *It is from the overall base in evidence provided in paras 3-6 plus Appendices that we now refute, repudiate and decisively reject Treasury paragraphs 34, 35 and 36.*

6. **Implications for high and low impact regulatory scenarios.**

6.1 Thus informed, one can entertain no reasonable doubt that, absent a crucially sustained and total failure of regulation spanning1987 and 1990 approximately, the Society would have been fundamentally different in character. *Moreover the ill effects of this failure have continued through the PO's reference period until the present day, and affected the lives of a million or more subsequent policyholders.*

6.2 It is against this background that the PO's later remarks about the cumulative nature of her findings and your ideas for a minimally changed Society with its dependent Head B comparator plus high and low regulatory impact scenarios must now be viewed. If the premise in support of minimal change is invalid, then so too is the rationale for high and low impact scenarios subservient to that constraint. We have moreover already seen that the various regulatory options under these scenarios hypothesised by Towers Watson [4] are subordinate parts of a causally related whole, such that they should not be viewed as separate entities when reverting to a more narrowly Report based approach. *Rather they are interdependent epiphenomena. Failure to consider them as such is an aspect of defects and biases in your advisors' isolating counterfactual approach to maladministrations 2, 4 and 5.*

6.3 We should therefore be duly grateful to Dr Andrew Goudie for having explained these methodological defects to you in a more expert and general way [21].

7. Counterfactual bias illustration 1.

7.1 With all this now in mind, Peter Scawen has in a forthcoming letter [22] pointed out the option of reducing bonus rates by the required amounts is tantamount to commercial suicide. We have all encountered this absurdity before when rejecting relative loss proposals based on an estateless comparator only able to provide cautious lower quartile investment returns. Now, of course, we have also to re-emphasise that rejection all over again in dealing with Mr Wiscarson's latest observations on Solvency II (see 15 below) [23].

7.2 Hence again, given that the PO's own findings of maladministration should be viewed collectively and cumulatively if not alas yet causally (see 13 below), there is no place for either the high or low impact scenarios. They contribute nothing just or meaningful to compensation for past losses or those going forward.

7.3 They are also based on a fundamental refusal to appreciate the essential nature of with profits assurance business, to the enduring shame not merely of your advisors, but the UK actuarial profession as a whole. To pursue them any further is demonstrably unfair, and they should be abandoned.

8. Counterfactual bias illustration 2.

8.1 Following on from Peter Scawen's observation [22], one of the problems with quasi-zillmerisation is that if in recurrent single premium business the inflow of premium dries up following lack of confidence, then liabilities are correspondingly uncovered. Thereafter the shortfall stands to be recovered from present and future policyholders, if any. That is, however, contrary to the essential philosophy of with-profits business. And so, if quasi-zillmerisation is fundamentally inappropriate and improper, it is equally improper to transfer the liability from a future premiums-dependent item to a future profits-dependent item under cover of Section 68 orders. This throws all the liability onto the accumulated premiums base rather than any future one.

8.2 I think you will find that the figures show that is what happened when the quasi-zillmer was discovered by the regulators. *Though it is a neatly simple way of concealing their oversight, it also a fundamentally objectionable example of reverse regulatory arbitrage (see Abbreviations and Definitions).* In any case over-reliance on Section 68 relief has received generally adverse comment by both Lord Penrose [7] and EQUI (Report p65-7 [6]). *It inevitably follows that further increasing future profits implicit items is not an option in counterfactual scenario building, and one must be surprised at your advisors*

for advocating it in the first place.

9. Implication for the proposed Head B loss comparator.

9.1 Had the Treasury's amoral case for the Society's business model being a matter of ordinary routine succeeded, then it would have followed that there was no important regulatory failure in the 1980's. In that case the Society might properly have been assumed to have continued with little change. (In effect this is manifestation of official myth (h) in my Feb 8th letter [13].) Had this argument in turn succeeded, it would have lent some legitimacy to the use of a separate Head B comparator, and one subject to a lower regulatory impact scenario at that. *Now that this line of reasoning has been demolished there is no moral or practical case for a separate Head B comparator, and it too should be abandoned.*

9.2 Even so I am grateful for Mr Emmett's latest expression on March 29th [3] of your current resolve to continue with a Head B comparator. And yet I am bound to say that the conjunction of the all above considerations is a major aspect of your correspondents' disquiet. *The sadly practical reality is that, should you now persist with the unreformed Society-minimal change-lowish impact counterfactual Head B comparator, your Final Report will almost certainly be widely rejected.*

10. Positive and negative asset-based approaches to past and future loss.

10.1 *Again, had the case for a low regulatory impact scenario which itself denied the essentials of with-profits assurance business succeeded, then the consequences for both past and future relative loss estimates of those having to continue with ELAS and perhaps also the WPAs would have been very serious.* Two further elements remain to be addressed, and they are a) the absurdity of a prudentially based approach to consolidated benefits only when the majority of loss was contrived to fall mainly on unconsolidated ones, and b) the notion that with–profits assurance business could ever function correctly when in chronic overall deficit.

10.2 Viewed positively, excess assets (sometimes referred to as an estate) are required for smoothing, superior performance in the market place and the assurance elements of the business. It is these very qualities that Sound and Prudent Management (S & PM) and Policyholders' Reasonable Expectations (PRE) under UK Statute, the EU Third Life Directive and later Solvency II initiative have been designed to protect. For George Newton's earlier views on this subject please see Appendix I.

10.2.1 Viewed negatively, a deficit not only fails to provide the assurance element, but gives rise to an asset based investment earnings shortfall relative to the market as a whole. While Ponzi expansion, neglect of new business strain, future premiums/profits implicit items, subordinated loans and deferred finance treaties may be used to cover these deficits, they do so usually at extra expense rather than profit, and only postpone the inevitable disappointment of otherwise rational expectation. Again Newton made relevant observations on this.

10.2.2 It follows that, while the negative view can be used to assess past loss in relation to external comparators, it is no reliable guide as to what might happen later, i.e. the assessment of future loss. *On the other hand the positive view can be used as an objective criterion of loss independently or in conjunction with external comparators, and provides the necessary information to decide what assets should have been in place for normal function going forwards.* Conversely, that is why continuing denial of the necessity for free assets is so pervasively pernicious. Quite simply, free assets cannot be neglected in the appraisal of "Head B" future loss. And given what has already been established, they are also a logical essential in any "Head A" comparator as well. ***In conclusion, the free assets-based approach is the only one which permits a unifying as opposed to competitive approach across all classes of policyholder.*** *It also creates the*

appropriate analytical framework for dealing with accounting discrepancies between spot, run-off and ongoing business valuations. If ever it is necessary to dissect the effects of the Compromise Scheme of Arrangement any further, this is how it will have to be done.

11. **International ramifications of the free assets-based approach.**

11.1 *The EU will neither understand nor ultimately tolerate the absurdities of a UK approach predicated on a very restricted and incomplete "pseudo-prudential" appraisal of consolidated benefits alone. (Nor should nor will it be any more sympathetic to purely UK ideas on apportionment or public purse considerations.)* In no way is this consistent with the broad scope of European Directives aimed at the regulation of companies' entire business. A free assets-based approach to past and future loss compensation enables you to bridge the gap between European and purely UK politically driven considerations. *I strongly urge you to adopt it now, because if not it seems inevitable that any final report appearing after the Election will be vulnerable to post hoc suggestions that it has been trimmed to fit the outcome.* ***Conversely, let me hereby reserve a future EU position on behalf of both UK and international policyholders should the free assets-based approach fail to be adopted.***

12. **EQUI versus UK findings.**

12.1 It has previously been explained that no UK Equitable investigation has ever made a finding of UK or EU statutory breach for the simple reason that none looked in the first place. In the PO's case that is curious, given that EQUI [6] had previously established otherwise, e.g. succinctly on page 293: *"In relation to ELAS, the main failure of the UK, as established in Parts II and III of this report, was not incorrect transposition but failure by the administration to apply and enforce the provisions of the Directive. ES 3 makes it clear that such failure is considered to be a breach of Community law and is therefore treated accordingly. The factors used in determining whether a breach is serious are the same as the ones mentioned in the above paragraph in relation to incorrect transposition."*

12.2 The following paragraph explains why, according to ES 3, it would be difficult to establish that the breach of Community rules was serious, and that "*Only the authorities' failure to examine and monitor the reinsurance agreement entered into by Equitable in 1999" which was particularly criticised by both Lord PENROSE and in the Baird Report may be considered to constitute a serious breach for the purpose of Francovich."* On the previous page it was explained that: "…*Under the Frankovich case law, the conditions of liability are the following:*

- *The rule of law infringed must be intended to confer rights on individuals;*
- *The breach must be sufficiently serious;*
- *There must be a direct causal link between the breach of the obligation resting on the state and the damage sustained by the injured party."*

12.3 EQUI was, however, denied sight of the PO's Report [5], which was materially delayed by a large extra swathe of material belatedly discovered by the UK Government. Moreover, as has been pointed out repeatedly both in relation to that report and your process, most recently by Michael Josephs [28], causation has been gravely neglected. As you know, that has not deterred policyholder advocates from pointing out the essential causal links to you. O*ne can thus confidently say that, were the PO's incidental and deliberately ignored findings now to be reviewed by the European Commission, a number of them would justifiably be regarded as extremely serious. Much of the now well described reverse regulatory arbitrage that came to light there had the effect of grievously limiting the rights of those affected.* The UK failure properly to follow causation or to determine any statutory breach whatsoever is bizarre, and highly damaging to our national reputation.

13. The PO's evidential base, process and findings in relation to EQUI and the *Francovich* seriousness/liability criteria.

13.1 It has previously been explained why the idiosyncrasies and omissions of PO2 made it essential for you to adopt a more flexible approach (MN IR2 letter Appendix I [13]). They have now to be explored further in the context of EQUI's findings concerning the Third Life Directive and *Francovich* [6].

13.2 Firstly, the PO's "Procrustean bed" (see Abbreviations and Definitions) ignorance of new findings, method of economical ruling and the causal anomaly of making all GAR matters subordinate to reinsurance matters have the combined effect of limiting *Francovich* concerns to those already identified by EQUI, i.e. prior to PO2 and without benefit of sight of it. ***That strange hierarchy and scope of judgment no longer passes scrutiny.***

13.3 Secondly, as pointed out in the previous paragraph, the suppression and turning of the PIA mis-selling report plus the neutralisation of the Warren opinion [21] had very serious effects on individual rights, such that the PO should not have followed the "Procrustean Bed" technique and ignored it given the overarching aims of the Third Life Directive, which EQUI had already determined to have been breached.

13.4 Thirdly, the PO's evidential base and findings have obvious implications for EQUI's page 222 overview of the Compromise Scheme of Arrangement, namely: "*In summary, evidence suggests that the primary aim of the Compromise Scheme of Arrangement, which took legal effect on 8th February 2002 after it had been approved by the requisite majority of policyholders and sanctioned by the High Court, was to remove legal uncertainties and liabilities from Equitable Life and thereby stabilise the fund. The Scheme, however, did not serve to compensate policyholders for losses they had incurred through the 2001 reduction in policy values, which was caused by a number of particular circumstances at Equitable, including the Society's practice during the 1990s of paying excessive bonuses. In particular, uplifts in policy values granted to non-GAR policyholders, who in exchange waived their right to pursue claims, were more than eliminated by subsequent cuts. Numerous accounts suggest that the Society may have been aware at the time it proposed the scheme that uplifts in policy values could not be sustained under normal circumstances. However, it failed to communicate this to policyholders, who may well have voted against the scheme, had they been made aware of the full state of the Society's finances. The committee concludes that the eventual result of the Scheme was such that all remaining policyholders lost their right to pursue claims against the Society while their losses continued to increase.*"

13.5 It is now abundantly clear from the succession of events in the PO's Chronology [5] around the time of the Society's failure to find a buyer onwards that the UK prudential regulators and GAD were perfectly well aware of all this, and more beyond [10]. *Not only did they fail to prevent it, but they relied upon it as part of their overall strategy.* Should the European Commission have occasion to revisit this area and PO2, they will have little option but to conclude that here again the *Francovich* criteria were met, and that this also constituted a serious breach of the regulations. Alas once again the "Procrustean Bed" technique of UK inquiry is relevant.

13.6 The above exemplary listing of *Francovich*-related items is unlikely to be exhaustive. For example, the FOS position and how it was brokered might also qualify, as touched on in paragraph 2.4 above. Your correspondents and other parties may well have their own ideas on this subject in due course.

14. The principle of reciprocity of rights as it affects UK, EU and other international policyholders.

14.1 With the above two paragraphs and the possibility of a further EU Commission or Court

Review of the PO's process and findings firmly in mind, we may consider the first two remedies recommended by EQUI (page 362 [6]):

14.2 *"10. In view of the UK Government's failure to comply with the recommendations of the Third Life Directive and given the absence either of accessible legal redress through the courts or of effective alternative means of redress, the committee firmly believes that the UK Government is under an obligation to assume responsibility. The Committee therefore strongly recommends that the UK Government devise and implement an appropriate scheme with a view to compensating Equitable Life policyholders within the UK, Ireland, Germany and elsewhere.*

14.3 *11. The committee urges the UK Government and all affected parties to accept and implement appropriately any recommendations the UK Parliamentary Ombudsman may make with regard to Equitable Life.* ***The committee recommends that the Irish, German and other host member state authorities actively assist their citizens in implementing those recommendations."***

14.4 That means implementation in full and assumption of responsibility. A grudgingly implemented *ex gratia* scheme with some of the PO's findings excluded would not appear to qualify. It also means that UK, Irish and German policyholders should have equal rights under EU law, such that they may not be treated differently. *It would thus be improper to apply full compensation as recommended by EQUI only to Irish and German policyholders in order to pacify their jurisdictions, but a lesser degree of ex gratia compensation to UK policyholders and non-EU nationals.* (Whether or not the exclusion of German policyholders from the terms of the Compromise will bear re-examination in this context is a contingently relevant point.) If one set of policyholders qualify under EU law, then all must do. And given what we now additionally know, a further EU *Francovich* review can very reasonably be expected to have serious consequences.

14.5 It is in this wider context that we should all note, respect and sympathise with everything that Laurence Emmett has lately said [3] about the limitations of your own remit. *Nevertheless it does not automatically follow that your flexible approach should be insensitive to the many important matters which bear on it.* In fact, as mentioned in my e-mail to Simon Bor of March 31st [25] everyone owes you a debt of gratitude for the transparent manner in which these contingencies have been raised; indeed you have introduced a number of them yourself. Through no fault of your own there is a whole herd of elephants in the gallery of your court, and you are getting to know them and why they are there just about as well as the rest of us. Obediently as usual, they follow their 1973-1990 matriarch around and about in a long causal procession. Taking implicit account of that herd is all part of the challenge of a flexible approach, and indeed explains why it gained universal approbation in the first place. If that has become as much a matter of diplomacy as justice then so be it, given that the latter has been so sadly and repeatedly abused in the UK by the authorities themselves.

15. The importance of EU Solvency II for loss considerations.

15.1 ELAS Chief Executive Chris Wiscarson has recently made public reference to the need for ELAS to hold back on bonuses and increase reserves when the EU Solvency II initiative takes effect [23]. Solvency II has been a long time coming, and as such is no surprise. EQUI made its deliberations with Solvency II in mind, and one conversely anticipates that the EQUI experience will have been a major consideration it its final form. Mr Wiscarson's observation does, however, point clearly to the fact that, as noted by EQUI, the Society's ongoing deficiency of free assets was not properly advertised in the Compromise Scheme of Arrangement [6]. *Had the necessary free assets then been in place, Solvency II would now have only minor impact. As a result, we have now to acknowledge that the coming loading for Solvency II is an important indicator of the wider need to address continuing loss going forward in addition to the hidden past losses of the Compromise Scheme.*

15.2 It follows that this aspect of future loss compensation is amenable to computation using a free assets-based system of actuarial accounting.

15.3 It is very much to be hoped that Mr Wiscarson will raise the overall significance of Solvency II with your Office, with a view to having it taken into consideration in future loss. *Should he do so, one further hopes that he may go further, and embrace the free assets-based approach to all outstanding issues as a logical consequence of what is now required in response to Solvency II.*

16. **The conclusion that a free assets-based approach is essential for future loss calculation is now inescapable.**

16.1 It provides the necessary context for understanding the predicament of WPAs transferred to the Prudential as detailed in Appendix II of my letter of March 12th [2]. ***As above, it is also a pre-requisite for enabling Equitable Chief Executive Chris Wiscarson to determine and agree future loss estimates for the hundreds of thousands of policyholders still in his care.*** *Finally and more generally, the free assets-based approach is the only one which enables you to resume an overall flexible approach which properly comprehends unconsolidated as well as consolidated benefits, and hence the general requirements of the European Third Life Directive in addition to UK statutes. As we have previously seen, it also serves to unite rather than divide the interests of all classes of policyholder.*

17. **Current understanding of apportionment and liability.**

17.1 In his recent letter to you [21], Dr Andrew Goudie, like Michael Josephs before him [26], has raised a number of important points on joint and several liability in respect of apportionment, all of which I support. In particular, current UK governance practice assumes full compensation, and EQUI has made the overall recommendation that policyholders should be put back in the position they would have been in had maladministration not occurred. But still you have to reconcile all that with the PO's Report statement that policyholders should not be put back into the position they enjoyed prior to the cuts of 2001 (but please remember that my preference is for total policy values immediately prior to the House of Lords decision as the reference point).

17.2 We have also seen that apportionment based on the notion that the Society was the author of its own misfortunes entails the concept of members' rather than policyholders' joint and several liability [2 Appendix I], irrespective or whether in present circumstances such apportionment can be considered to have any merit at all. (Annuitants as a class are policyholders and not members.)

17.3 I have previously made the point to you that joint and several liability is the only reasonable way of approaching an injustice perpetrated by several parties in knowing co-operation of something later judged to have been maladministration or worse [27]. Hence it seems inherently unfair to apply the principle of joint and several liability to ordinary members, but not the regulators or their agents.

17.4 Michael Josephs and I have also explored the practical side of recovering apportionments, as a result of which I believe it is fair to say that such recovery is the job of Government and not policyholders. You were previously entertaining the idea of apportionment depending upon the outcome of the disciplinary proceedings appeal by Ernst and Young, but your latest timings would appear to preclude it. There is the further consideration of an Actuarial and Accountancy Disciplinary tribunal hearing in respect of one or more members of GAD. *One would not wish policyholders to be denied any further elements of redress due to them had you been able to consider the facts of these cases as they might affect duties the regulators should have performed. With this in mind, pray let me reserve a future position on the matter should it turn out to be of practical importance to the magnitude of compensation regardless of apportionment.*

Moreover if, like Arthur Andersen before it, E & Y now faces annihilation following the Lehman Brothers fiasco, arguments about magnitude of compensation rather than apportionment *per se* may be the only ones which matter in the end.

17.5 As a final point, it may be wise to recall the wider interest of other jurisdictions and EU *Francovich* concerns before reaching any firm conclusions on apportionment and liability. *In this setting the pivotally important example with respect to both past and future loss determination is the Compromise Scheme of Arrangement.* Given EQUI's summary view to the effect that the Compromise Scheme of Arrangement was a Trojan Horse for passing off accumulated deficits of all sorts under more general forfeiture of rights [6], as we now know with the full awareness of the UK regulators [5, 10], it is plain that it amounts to a serious breach of the EU Third Life Directive. Forgive me therefore for reminding you that it may be more appropriate to consider apportionment on joint and several liability grounds to Compromise-mediating accountants Bacon Woodrow Deloitte than E & Y, and to the ELAS management team the regulators themselves had been instrumental in engaging to effect the Compromise. FSA Head Sir Howard Davies, who sat atop the reporting lines on either side of the prudential/CoB interface, was then in place as he also was during the prudential/CoB interfacial matters which have surfaced repeatedly in your correspondence. Other jurisdictions might therefore now consider him to be the appropriate link in apportioning UK Government *Francovich* liability on entire business, prudential and CoB grounds generally under the Third Life Directive in reconciliation with the PO's more limited UK scope, evidential base and findings.

17.6 (*Francovich* in Europe may in due course have to be set against current UK seriousness criteria, and looked at further in consideration of what constitutes misfeasance and malfeasance in the EU and UK. And as I imperfectly recall from your earlier correspondence, such considerations might also have knock-on effects in purely UK matters of apportionment and liability.)

18. Further observation on netting of gains and losses across policies.

18.1 In explaining my views on this subject I have hitherto examined the effects of netting within and across policies, but not what happens to policies running in series rather than in parallel. Where one policy rolls over into another in a series, it is clearly appropriate to continue the quasi-internal netting of gains and losses as though both policies were one and the same. But where asynchronous and different policies run for more or less time in parallel, netting of gains and losses across them is inappropriate and potentially unfair. So of course it is for unrelated policies running in series, because internal netting of each separately will already have been carried out such that across policies netting is superfluous. Hence other than the exception now explained it should have no further place in your considerations. Please accept my apology for this omission, and for the confusion it must also have caused.

19. Further observations on data and transparency issues.

19.1 My colleague Michael Josephs, who as you know has been making a detailed ongoing numerical analysis of the Society's asset shortfalls in contrast to the surplus that free assets should have generated, has become both sadly frustrated and angry with the continuing lack of relevant information as he sees it. Having made his point, he has handed the overall problem back to you because no time remains for him to assist you [28]. *This is most unfortunate, because Mr Josephs' approach is insightfully different from EMAG's, which traditionally ignores the free assets-based fraction of earnings shortfall.* Though Mr Josephs has as usual spoken well on his own account, one must also keep in mind the more pivotally specific outstanding data issues. These include:

19.2 - Incoming Appointed Actuary Peter Nowell's fund valuation, which is crucial to understanding how all the losses after July 2001 were hypothecated, postponed or disposed before, in and after the Compromise Scheme of arrangement. We have

repeatedly seen that the Compromise Scheme is pivotal to the assessment of both past and future loss. *Hence the Nowell valuation is essential for any forensic actuarial and accounting approach to the Compromise on wind-up, run-off and ongoing business accounting conventions, and to all the policy value cuts imposed before and after it.*

19.3 - The missing records spanning the Society's fraudulent transition, pivotally catastrophic regulatory failure, and unrestricted crystallisation of benefits prior to the implementation of the GAR and Guaranteed Interest Rate (GIR) differential terminal bonus policies.

19.3.1 With regard to these latter data, footnote 30 on page 23 of IR3 records: *"I, and my advisers, are aware that Equitable Life did maintain electronic records prior to that date (1992-MN). But, for the most part, the data in such records is stored on data tapes and (I am advised) would now be very difficult to access, even if the tapes have not become corrupted with the passage of time. My present view is that, since data relating to the vast majority of individual policyholders (other than members of group schemes) is available back to a point not long after the earliest appropriate start date, it would be an unnecessary diversion of time and resources to attempt to read the data tapes."*

19.3.2 With due respect plus a little trepidation, give me leave to say that if in your judgement there is need to apply some sort of adjustment to specific ages and classes of policyholder prior to 1992, then the matter is sufficiently important that data recovery from these tapes should also be attempted. *If necessary, the task could be put out to tender following preliminary feasibility studies by information technology (IT) consortia sufficiently skilled and furnished in the art.*

19.3.3 Should this be done expeditiously, and if possible in consultation with some of the IT personnel who generated, handled and stored the tapes in the first place, more rapid progress might be made than initially anticipated.

19.3.4 Likewise, one can be overly pessimistic about the robustness of data on high duty archival quality tape, for which a number of data clean up, enhancement and signal-noise reduction techniques are well known and widely available in various expert fields.

19.3.5 Finally, these data are of obvious forensic importance, such that suitable forensically validated recovery techniques may have to be used on them in any event. *Now we know that they exist, they should be duly catalogued, appropriately stored and if necessary backed up or copied with this in mind (Indeed they should have been backed up already as a matter of competently secure routine. Ordinarily this permits coincidence checking as an aid to data clean up). **Conversely everyone should now ask why, if they have always existed, they were not made available and read previously for Lord Penrose, EQUI and the Parliamentary Ombudsman.*** It all smacks of our habitually understated and tactful reluctance in comparison with American enthusiasm and determination.

20. **Persistent concerns about your advisors and actuarial peer review**.

20.1 Before getting to the nub of this issue let me first deal with page 4 point 6 of Mr Emmett's March 29th letter [3]. He writes: *"Your professed 'concerns' regarding Towers Watson are without substance. Moreover, it is incorrect that the panel which has been appointed to review Towers Watson's work was selected by Towers Watson. It was not. It was selected by Sir John, from a list of those senior members of the profession with relevant experience whose other interests do not give rise to conflict"*. This sent me back to your Office website, whence I recollected gaining the contrary impression. And there under 4th March I found: *"Sir John will review all representations he receives while his team continue its further detailed analysis. To assist Sir John in deciding whether it is reasonable for him to rely on its advice, Towers Watson, has appointed a panel of three senior and independent actuaries, to peer review its actuarial assumptions and methodology. Sir John welcomes its appointment. The Panel is comprised of Gavin Hill FIA (Fellow of the Institute of Actuaries -MN), Peter Shelley FIA and Michael Urmston FIA, none of whom have or had any connection with Equitable Life."*

20.2 I think that my colleague Andrew Goudie must also have placed reliance on this

passage, and so perhaps you could tell us both which construction is the correct one: that of Mr Emmett or your website. *Meanwhile, let the entire record of our correspondence duly show the extent to which my "professed 'concerns'" about your advisors and the quality of their decisions have any substance, let alone more secure foundation.*

20.3 Assuming Mr Emmett is correct and that your website will be modified accordingly, I doubt that Dr Goudie and I are yet fully reassured. A senior AXA UK actuary from 1990 onwards and another with historical links to Aviva Life may on first principles be presumed to have some ordinarily loyal interest in their offices' past, present and future practices. The 2000 AXA estate raid which so infuriated the late Dame Sheila McKechnie and the contentious Aviva estate reattribution which so exercised policyholder advocate Claire Spottiswoode are, however, matters in principle contrary to those which should obtain when re-establishing a traditional with-profits estate-based approach to the assessment of past and future loss. Pray therefore let our objection stand for the time being. That said, you have now kindly sought assurance from Towers Watson that the senior partner who was instrumental in giving the residually problematic go-ahead to the transfer of ELAS WPAs to the Prudential [2 Appendix II] will not be involved. Some similar reassurances in respect of or from Peter Shelley (AXA) and Michael Urmston (ex-Aviva) might therefore help the current situation.

20.4 Besides the free assets or estate perspective, we have previously seen that there is the additional problem of how to compensate Equitable victims for loss of mutual advantage both in the past and the future. Gavin Hill was The National Mutual Life Assurance Society's managing director, and was both party to and a beneficiary of the demutualisation and sale of National Mutual to GE Capital of the US in 2002 [29]. (Interestingly, GE is reported to have been one of the companies that failed to buy ELAS the previous year). It turns out that Clive Cowdery of predatory insurance consolidator Resolution was Chairman of GE Insurance Holdings at the time. (Of further passing interest to battle-hardened Equitable veterans is that Lovells LLP (Limited Liability Partnership) acted for GE Capital, and Herbert Smith LLP acted for National Mutual.) At the end of 2007 the ex-National Mutual with-profits fund was passed to Windsor Life, a subsidiary of Swiss Re. Though it does not automatically follow that the ex-National Mutual Fund should now be classified as an asset-stripped "zombie" fund, I hope you will forgive me for pointing out that, under the circumstances, Mr Hill's pedigree is not perhaps ideally consoling. *That said, it cannot be emphasised too strongly that such observations should not be taken as personal. Rather they are a reminder that professional life history and custom may condition personal attitude and opinion independently of integrity.* Meanwhile, to see George Newton's earlier concerns on the ever present dangers of estate predation please consult Appendix I.

20.5 By now some of us must be half hoping that your website is right and Mr Emmett is in error! Certainly it all reinforces Dr Goudie's more general observations as to what principles and customs are honoured in pursuit of more impartial peer review elsewhere [21]. As regards lay membership of a peer review panel Dr Goudie has proposed Peter Vicary-Smith of the Consumers' Association as the inheritor of the late Dame Sheila McKechnie's stance on estate predation. Unfortunately I have previously failed to interest him or his associate Dominic Lindley in taking up her allied position on the Equitable Life scandal, and so he might not be interested. The admirable if very busy Dr. Ros Altmann is my personal preference, with Claire Spottiswoode as runner up. When it comes to expert wise heads, inevitably I wish that Marshall Field and George Newton might be alive and well enough to come out of retirement and assist you. The outstanding choice for a contrarian and academically wise head among those still in practice must be your correspondent David Forfar. His record plus submissions to you and the Myners Commission [30, 31] duly show that he would readily and impartially understand the complexities of the task ahead of you, both in the UK and Europe. Otherwise one might consider a respected present or past Appointed Actuary from Liverpool Victoria, a mutual office which has hitherto both properly understood and respected the traditional estate-based with-profits ethic. So finally we come to Dr

Goudie's recommendation that a non-UK actuarial firm should be scrutinising your process, in which case international policyholder numbers suggest a Republic of Ireland representative.

21. **Residual aspects of Mr Emmett's March 29th letter.**

21.1 Having now reproduced Treasury paragraphs 34-6 *verbatim* and gone further into the situation, I trust that the first two main paragraphs of page 1 are thereby answered. I must, however, confess to telescoping my logic as to why the society would have been "radically different" rather than "different" in character in such a way as might imply that a former policyholder (AFP) might have said it. Expand the logic, and all should be clear enough; meanwhile let me apologise should AFP think I have taken the position in vain- although I would like to think that AFP too might now like to add "radically" for the same reasons as I did.

21.2 I hope, too, that enough has now been said about the gravity of regulatory failure and its concealment by the UK authorities to make clear my view that , although IR3 para 6.4 applies on first principles to regulation in general, it has little if any specific application to the very serious situation in which now we find ourselves.

21.3 With regard to Sir John's response to EMAG, in my IR2 submission [13] I agreed that it was absolutely proper that Sir John should address maladministrations 2, 4 and 5 in reconciliation of report based and flexible approaches. *But because of the idiosyncrasies in the PO's investigation and Report which we earlier re-examined, it is not sufficient then to look at them cumulatively. One must also at them causally.* What is more, other jurisdictions will in due course be disposed look at all the PO's findings, and not merely those allowed you by the Treasury. Similar consideration apply to the "Absent serial maladministration…" argument, save there will be even more need to look at the catastrophic failure of regulation prior to PO2. You might strictly and rightly say that none of this is in your immediate brief, but should your decisions be placed ultimately in that more widely relevant context then I think further complications will ensue.

21.4 I am glad to find at the bottom of page 3 that non-GARs generally and not just late joiners and WPAs are in your "disproportionate impact" group. *That makes about a million people in total, which does not seem very exclusive. Even so it might have been simpler to say that GARs as a category have not suffered disproportionate impact.* But still the situation is unsatisfactory. As Dr Goudie has pointed out to you, impact should be determined at the individual rather than the categorical level [21]. I think this bears on what I submitted to you in para 19 of my IR1 letter to you [27] which concluded with the words: "*If disproportionate impact is plainly and simply a logical extension of relative equity then it might just prove acceptable. If it is an absolute and arbitrary hurdle then for reasons of prior vested interest it will not."*

21.5 As a further example of how broad categorical exclusion can be unfair, may I again refer to the late GAR case? In section F page 19 of my IR2 response [13] I have previously used late GARs to illustrate how cumulative individual impact assessment is effected by the netting of gains and losses within policies, as follows: "*Having reached this point, spelling out the details of an overall procedure is far less important than making sure that the critical points in it work properly. The most convenient way of doing so may be to track those policyholders affected by all the critical steps in succession to confirm the necessary robust fairness. Early GAR + GIR policyholders who after 1993 exchanged the GAR for an income drawdown policy or WPA would seem to fit the bill. In any relative compensation scheme, the balance of any early deductions against later compensation for such long duration policyholders must be both right and clear.* " I think that this all adds up to the fact that, if disproportionate impact is ever to have any transparently fair meaning at all, it will have to be worked out by a process of overall integration at the individual rather than the categorical level.

Summary and conclusions.

On the assumption that you would not answer the questions posed at the end of my urgent letter of March 12th I had proceeded to answer them myself prior to receipt of Mr Emmett's further letter of March 29th. I trust that this letter has both consolidated the underlying arguments, and now answered those same questions to your satisfaction. It has been established that no reasonable person would have agreed with the amoral and even fraudulent position which the Treasury contends is no more than a routine business decision. Irrespective of the fact that the Treasury's contention introduces conduct of business matters, that amoral position could only have gained acceptance over a prolonged period by a process involving stealth, sustained misrepresentation and conscious deceit. The essentials of that process have been summarised for you. You had yourself previously introduced a conduct of business assertion that there was no misrepresentation in these or related matters, but have now discovered otherwise. From this it inevitably follows that there was a pivotal and catastrophic failure of regulation in the 1980s. Whether on a narrowly UK prudential or entire business EU view, we have also gone on to see why in retrospect that failure is so very hard to justify. *It is even harder still to justify the fact that this essentially fraudulent transformation and pivotal regulatory failure have been so assiduously avoided by the authorities. This is a chronic disgrace, which continues to fill an already over-large graveyard of personal reputations. Such is the true measure of public outrage. And that in turn is why the matter of previously missing data for this period is so very sensitive and serious.* Not only that, but it has led you to make assumptions about this period which your advisors should already have known from the existing literature were mistaken.

The principal effect of this long line of reasoning has been to demolish the contention that absent maladministration of any sort whatsoever the Society's character would have been little different. That in turn invalidates any legitimate pretensions to a lower quartile return ELAS lookalike, a separate Head B comparator which in so many ways resembles it, or the high and low impact counterfactual scenarios which depend on that contention. All this apart, we have seen that dependent pretensions of this sort could only have been made in the first place by ignoring the fundamental fiduciary aspects of with-profits assurance business, which inevitably raises questions about the entire UK actuarial framework rather than your advisors in particular.

Such fiduciary matters inform both the overarching aim of the Third European Life Directive and the broader tenor of UK regulation. Together they embrace both prudential and conduct of business aspects of S & PM and PRE, and indeed the "fairness" of the succeeding era. Hitherto policyholder advocates had supported the flexible approach as the only way to get round the fact that PO2 took a very narrowly parochial and time-restricted view of some prudential aspects only. As has been explained, it has also led to a very unsatisfactory position from the perspective of EQUI on behalf of the EU Commission, which having been denied prior sight of PO2 had nevertheless unconditionally hoped would be implemented in full. It is therefore as much for the EU and international policyholders' benefit that the regulatory aspects of this, notably including those prior to the PO2 reference period, have been reconsidered. Now we must additionally contend with the unwelcome discovery that the bizarrely blinkered reporting process and causally inverted economical structure of the PO's judgments has the effect of limiting serious breach and liability aspects of the EU Life Directives to the one instance EQUI had previously determined without the expected benefit of her Report, namely the reinsurance treaty. So it is that, if EU *Francovich* criteria of seriousness provide any guide as to what might happen should the EU now have to review Equitable Life compensation with PO2 in mind, then the consequences for the UK could well be very serious.

In order to pre-empt these difficulties one may return to George Newton's prophetic memorandum of 1988. It places all relevant UK regulatory failure in an appropriate context, and from both the EU and UK legislative viewpoints. It also informs us as to how a flexible method of compensation might be effected in a manner consistent with a properly comprehensive legal and fiduciary regard to PRE and S & PM, as well as to PO2's more limited findings. In short, it could get everyone off a

most unpleasant hook.

While Newton might get us off the past losses hook, he does not anticipate the future loss problem so directly or conveniently. As we have also seen, that requires the restoration of the traditional custom and ethic of a free assets-based approach, which unfortunately runs counter to much of UK actuarial vested interest. It is, however, the only sure way of dealing with the predicament of Equitable's remaining policyholders, or indeed the WPAs if ultimately a single payment which embraces both past and future losses is not made to them.

As to how you more immediately proceed, despite your recent efforts the collective vested interest of the UK actuarial profession is widely seen as a persistent problem. Though you have sought reassurance for everyone over Watson Wyatt's handling of the Prudential transfer and the residual difficulties we now face as a result of that, the appointment of one or more actuarial referees from offices whose reputations may have suffered on account of estate predation or an inimical attitude to the mutual free assets-based approach must remain a matter of considerable apprehension and regret. With this in mind, some suggestions have been advanced in pursuit of the more generally accepted approach to peer review.

Finally, you may sense a growing and general doubt that the flexible approach can resist the steadily accumulating pressure of highly relevant external factors within the confines of your existing brief. If so, might I ask you consider obtaining the immediately necessary extension of your authority from the Secretary of State as the constitutional head of regulatory supervision if not from the Treasury? After all, had UK statutes been properly respected, the Secretary of State would have been consulted long before now. And please understand that I mean well by venturing to add that too much further delay could leave your Office open to the later suggestion that it might have been looking to finesse the outcome of the forthcoming General Election.

I trust that this letter is sufficient preparation for any future meeting, but should you need anything further please advise.

Yours sincerely,

Dr Michael Nassim.

E-mail copies: Peter Scawen (ELTA); Michael Josephs; Nicholas Oglethorpe; Dr Andrew Goudie; Margaret Felgate; John MacLeod; Ann Abraham; Iain Ogilvie; Dr John London; Liz Kwantes (ELM); Paul Weir (EMAG/ELCAG); Alex Henney (EMAG); Nicolas Bellord (EMAG); John Newman (EMAG); Christopher Carnaghan (EMAG); Colin Slater (Burgess Hodgson & EMAG); Paul Braithwaite (EMAG); Markus Weyer (DAGEV); Diane Wallis MEP; Mairead McGuiness MEP; Tony Wright MP (PASC); Andrew Tyrie MP; Vince Cable MP; Alan Duncan MP.

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Abbreviations and Definitions:

BWD: Bacon Woodrow Deloitte.
CoB: Conduct of Business.
DTBP: Differential Terminal Bonus Policy.
DAGEV: Deutsche Arbeitgemeinschaft der Equitable Life Versicherungsnehmer.
ELAS: Equitable Life Assurance Society.
ELCAG: Equitable Life Late Contributors Action Group.
ELM: Equitable Life Members support group.
ELTA: Equitable Life Trapped Annuitants.
EMAG: Equitable Members Action Group.
EQUI: European Parliament: Committee of Inquiry into the crisis of the Equitable Life Assurance Society
EU: European Union.
E & Y: Ernst & Young.
FA: Faculty of Actuaries (Scotland).
FOS: Financial Ombudsman Service.
FSA: Financial Services Authority.
GAD: Government Actuary's Department.
GAR: Guaranteed Annuity Rate.
GIR: Guaranteed Interest Rate.
IA: Institute of Actuaries (England).
IR1, 2 & 3: Chadwick First, Second and Third Interim Reports.
IT: Information technology.
LLP: Limited Liability Partnership.
MN: The writer.
PIA: Personal Investment Authority.
PO: Parliamentary and Health Service Ombudsman.
PO2: Parliamentary Ombudsman's Second Equitable Report.
PRE: Policyholders' Reasonable Expectations.
S & PM: Sound and Prudent Management.
WPA: With-Profits Annuitant.
WPWM: "With Profits Without Mystery".

Reverse regulatory arbitrage: Regulatory arbitrage is generally understood to be exploitation of the minutiae of statute, regulations, professional standards and guidelines in a manner contrary to their collective aim and spirit by regulated organisations or persons. Hence, when the regulator employs the same tactics against those it should protect it may be termed "reverse" arbitrage.

"Procrustean Bed" complaints handling: A process of aligning complaints under specified headings according to prior criteria, without due regard to significant new evidence which gainsays those criteria, or to material and relevant deviations from the headings to which the complaints have been assigned. It takes its name from the racking or hacking of the limbs of his guests by the mythical Procrustes so as to fit them in his bed.

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APPENDIX I:
The Newton Memorandum.
(Reproduction of Penrose Chap 13.105-12)

In Chapter 13 of his Report, Lord Penrose made a comprehensive historical approach to the concept of PRE, and the extent to which the issues surrounding it had been picked up by working parties, statute, guidelines, precedent and custom. The preface to this extract is that in 1988 Arthur Russell, Head of Insurance at DTI, had prepared a draft proposed submission to the Consumer Affairs Minister in guidance for a general policy position on PRE with regard to insurance matters. As will become clear, many of the considerations expressed in Lord Penrose's abridged exchange reproduced below are prophetic with regard to the Equitable, and anticipated the concept of S & PM as later expressed in the Third Life Directive. As a result it cannot be held that the DTI and GAD should not have been fully conversant with the issues. The question thus becomes why this approach was not applied later on, which is something that the Parliamentary Ombudsman's Second Report might have enlarged upon as requested. The Report does, however, make detailed reference to IA President Marshall Field's address "Risk and Expectations" (part two p91-2 para 429), which expressed many of the same concerns, although not so obviously from a regulatory viewpoint. The similarity between Field's and George Newton's approaches suggests that Newton may have paid considerable attention to Field's paper. Whatever, all these matters are now important from the European as well as the UK perspective. For the reader's convenience the more immediately relevant topics have been italicised.

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GAD became involved. George Newton, who was directing actuary for the insurance directorate at GAD from 1982 to 1988, provided a copy of a memorandum he had written on 21 September 1987 on an argument that had surfaced that section 45(2) of the 1982Act inhibited the exercise of the Department's powers generally rather than solely in respect of investment management. On 8 July 1988 Newton wrote a long memorandum to Russell and others:

> "I doubt whether much purpose is served by going in any detail into the origins of the "reasonable expectations" provision… but I would do so at least in order to correct what I have now discovered is a distorted version of history which I have been instrumental in spreading around.
>
> GAD folklore has for long had it that the origin of the reference to "reasonable expectations in section 37 of the Act and in particular the reference to the legislation to enable the power to make regulations for valuing liabilities, introduced in the same Bill, *to go beyond provision for a company's contractual liabilities but to extend also to direct or indirect provision for future bonuses to with-profits policyholders.*
>
> It is certainly true that the Instructions to Parliamentary Counsel for the 1973 Bill did draw attention to *the desire to make regulations for valuing liabilities which included provision for making bonus expectations of with-profit policyholders* and it was suggested that this extension of the concept of liabilities should be expressly spelt out in the Bill. However, a quite separate part of the Instructions on the Secretary of State's powers of intervention included the following:-
>
> Principal power
>
> *The Department should have power to require a company to take such action as may appear appropriate to the Department to protect policyholders and potential policyholders of the company…. from the risk that the company may be unable to meet its liabilities or, in the case of its long term business to fulfil the reasonable expectations of policyholders or potential policyholders.*
>
> I In the event the wording of this part of the instructions was, unusually, carried forward virtually unaltered into the Bill in what are now sections 37 and 45 of the 1982 Act but, possibly because this was done, Counsel saw no need to expand on the way suggested the regulation-making powers in what is now Section 90 of the Act.
>
> *It is clear, therefore, that the ability to meet reasonable expectations was included in the 1973 Bill as grounds for the exercise of the powers of intervention in its own right and not merely as a peg on which to hang valuation of liability regulations which prescribe a standard above provision for a company's minimum contractual liabilities."*

It appears equally clear from this insight in 1988 into the background into the Act that GAD had been proceeding for a material time on a false assumption about the scope of scrutiny that would have been appropriate. Regarding PRE as a peg for the valuation regulations would have led to the assumption that PRE was irrelevant except in so far as reflected in the valuation regulations.

108. Newton continued with helpful background observations:

"*Even if the "reasonable expectations" grounds had not been introduced in the 1973 Act as part of a package of measures designed to keep asset strippers away from the large free reserves held within life assurance companies (in particular to give teeth to what is now section 30), some such provision would sooner or later have become inevitable to match the changing structure of with-profits business.*

During the latter part of the 19th century and the early part of this century (the era reflected in the 1909 Act which effectively governed the conduct of life insurance business up to the 1973 amendment), the premium rates for with-profits contracts had been conventionally just 10% higher than for the corresponding non-profit contracts. Bonuses were distributed wholly in reversionary form so that the additional benefits were built up more or less uniformly over the term of the contract. In the circumstances the bonus loading could reasonably be regarded as a small equity interest in the insurance company and if during the course of the contract the company's treatment of its with-profit policyholders ceased to match up to their expectations, the policyholders were exposed only in regard to a very small part of their investment.

The margin between the with-profit and non-profit premium rates has gradually widened over the years but in the middle 1950s, the earliest date for which returns are to hand in GAD, the differential was still only of the order of 20% - 25% for a twenty year endowment assurance. For some years now, however, the corresponding differential has been 70%, with non profit savings contracts almost ceasing to be a significant class of business. *This has resulted from the effects of inflation which has taught policyholders the hard way not to rely on benefits fixed in monetary terms. The effect has been, however, wholly to change the character of a with-profits contract. I find it difficult to interpret a with-profit contract in current conditions as other than one where the policyholder entrusts the insurance company to do its best for him in the investment of his premiums and, in order to enable the company to invest heavily in assets such as property and equity shares which have performed well in the past but whose value at a future date is inherently uncertain, the policyholder accepts a guaranteed benefit representing less than half the return he can reasonably expect from his premiums.*

However, without any formula governing how the non guaranteed part of the return should be determined, there is clearly much scope for the inequitable treatment of policyholders, which is increased with the trend towards giving a very significant part of the return in the form of a terminal bonus when the policy matures.

On this general analysis of the nature of a with-profits contract, you will see that *we would fully support the view put forward in the draft submission that policyholders' reasonable expectations are to share in the success or otherwise of the company's investment policy, and in any other sources of profit or loss, and not to any particular rate of return on their investment. Clearly a primary application of the reasonable expectation concept will be in relation to the apportionment of the distributed profits between policyholders, as was originally intended."*

These observations would have been significant at any time during the 1980s as the allocation of surplus between reversionary and terminal bonus shifted. They have particular significance as one approaches the 1990s when that process accelerated. GAD in particular were clearly aware of the need for legislation and regulations to take account of changing industry practice.

109. Newton continued on the issue of competent and prudent management:

"We would also consider that the policyholder can reasonably expect that the company, and not just the funds, would be competently and prudently managed. In addition to the investment aspects, of which more below, this would cover the control of the expenses but should also include the company's rate of expansion where excessive investment in financing new business strain can lead to failure to meet reasonable expectations in regard to bonuses. Whether this is happening or not in a particular case is difficult to judge from outside the company and, as elsewhere, the Department would presumable (sic) expect to intervene only in extreme cases and would be largely dependent on the company's Actuary.

In practice the concept of prudent and competent management when applied to investment will come down largely to what degree of risk is considered to what degree of risk is considered to be in keeping with policyholders' reasonable expectations… However, even if the investment of a high proportion of the assets in a well spread portfolio of equities is regarded as in keeping with policyholders' reasonable expectations the concentration of a large part of the investment in, say, a single industry would clearly give rise to a risk that policyholders' reasonable expectations could not be met. *However, quite apart from the problem of laying appropriate criteria, at present we do not even get the information to enable a situation which might not be in keeping with policyholders' reasonable expectations to be identified. In effect we rely on the AVRs and again on the role of the actuary within the company to control the situation."*

110. Newton then discussed the development of non-profit business *before noting that the draft submission did not deal*

with whether reasonable expectations should extend to surrender values. He finished with a "general review which advised caution:

> "Whilst we recognise the need for guide lines in regard to the policy to be applied in using the statutory powers of intervention on grounds of reasonable expectations, the particular situations to which I have drawn attention above do I believe illustrate the need for flexibility and the dangers in saying too much in public. There are a number of aspects where it would be difficult to maintain that reasonable expectations were not involved but where DTI in practice would presumably only wish to intervene in extreme cases. In some areas we do not at present have the necessary information and others where the powers could probably only be exercised if more formal responsibilities are put on the Appointed Actuary."

111. On 1 August Russell sent a revised draft of the submission to Newton. Newton again replied at length on 8 September. It is unnecessary to set out the terms of the paper in full. Russell's revised draft, at paragraph 13, had referred to problems associated with timings of receipts of relevant information and said:

> *"But we and GAD are giving thought as to how the chance of such situations occurring can be minimised by giving greater definition to the role of the Appointed Actuary, and a more robust attitude to discipline by the .. Institute of Actuaries…"*

Newton commented:

"…as you may recall from Edward Johnston's notes and the discussion on 20th July, the exercise of disciplinary powers by the actuarial profession is a more complex problem than may appear at first sight…"

and proposed that the subject be left over for a later paper.

112. Newton also commented at length on a new topic:

"The situation in the paper on reasonable expectations in regard to the distribution of surplus is largely confined to the apportionment of profits between policyholders and shareholders, but issues of policyholders' reasonable expectations also arise in regard to the respective treatment of different classes of policyholders. Whilst I recognise that there is a limit to the aspects of the question that can, or indeed need to be referred to in detail in a submission to Mr Maude, while the subject is under active consideration by officials *I would draw attention to some of the main circumstances which may arise where the treatment of particular groups of policyholders may amount to failure to meet their reasonable expectations, particularly as the number of cases where the Department is asked to intervene on these grounds could increase significantly in the future.*

It is not suggested that DTI/GAD should become involved in vetting the equity of companies' bonus distributions as a matter of course. *However commercial pressures will always tend towards generosity in bonus distributions to those classes of policyholders where the company is competing most actively for new business and this may sometimes be carried so far as to prejudice the reasonable expectations of certain classes of existing policyholders.* This has been a major issue in Australia where a number of companies have ceased to write traditional with-profits policies and the Commissioner in successive annual reports has expressed his concern that surplus generated from the older types of contract is being applied to increasing the rates of dividend on the new deposit administration type of contracts that companies are currently marketing. The Australian Commissioner in one report went so far as to warn companies that if they did not mend their ways he might require the setting up of separate sub-funds in respect of the main classes of participating business.

The issue of policyholder's expectations may also be raised by changes to the form of bonus distributions. Although a particular bonus system, such as uniform reversionary bonuses may only do rough justice, it has generally been held in the industry that the method of distribution of surplus is part of the deal that the policyholder buys when he takes out his contract. Over the years virtually all the companies have come to supplement their reversionary bonuses with terminal bonuses which have gradually grown in importance with for some companies for longer term policies more than 50% of the total policy proceeds arising in this form.

The use of terminal bonuses to distribute a part of the surplus can certainly be justified as the only method by which policyholders can be given a full share of the unrealised capital appreciation on the assets in which their premiums have been invested. However, from the company's point of view there are other advantages in terminal bonuses in that compared with reversionary bonuses the time when surplus funds are converted into additional contractual liabilities to policyholders is deferred, thus increasing the company's capital resources available, for example, for financing expansion. Increasing pressure on capital resources for some companies in the future could well lead to a situation where profits came to be distributed largely in the form of terminal bonuses, but in the extreme cases this could raise the question of policyholder's expectations. The manner in which terminal bonuses are currently operated amount almost to a tontine system with benefits accruing disproportionately to the minority of policyholders who maintain their policies in force to the maturity date.

More generally, any sudden recasting of bonus scales can give rise to issues of policyholders' expectations. We have seen examples of increased (sic) in payouts on similar policies of the order of 30% or 40% as terminal bonuses have been introduced or greatly increased. Changes on this scale have certainly not added to the reputation of the industry or of the actuarial profession, since it is impossible to avoid the implication of very serious shortcomings in the basis for distribution of profits in the past, but there have generally been no actual losers and so far as we are aware the dissatisfaction that must be felt by policyholders whose contracts matured shortly before the increased (sic) has not been translated into formal complaints on grounds of reasonable expectation.

However in circumstances likely to rule in the foreseeable future, significant realignments of bonus scales are likely to involve losers as well as gainers and the Department has recently had a difficult case where a policyholder has complained about a significant reduction in the maturity benefit under his pension policy compared with an estimate given by the company a few months earlier for no reasons other than, as the policyholder sees it, an arbitrary decision by the company to revise the shape of its bonus scales. Fortunately in the present instance the company can show that the new scale is more soundly based than the one it replaced, but were this not so an awkward question of policyholders expectations not being met would be involved.

Whilst we fully share the sentiment expressed in para 19 of the draft submission that we should not be overzealous in the pursuit of possible unfairness, for the reasons I have indicated I fear that there might be many more complaints to DTI in regard to bonus distributions in the future than there have been in the past. It is very much in DTI/GAD's interests that the initiatives of the Institute of Actuaries, following the discussions last January that you attended, should be effective in bringing about a more structured and consistent approach to bonus distributions than has always been applied in the past."

APPENDIX II.
Abstract and commentary on the London and Edinburgh discussions of "With Profits Without Mystery" in 1989 and 1990.

Historical note: This abstract originally appeared in a paper entitled: "An Equitable Assessment of Rights and Wrongs". Among other things that paper contained a detailed analysis of WPWM, of which this abstract formed an integral part. The paper was written before Lord Penrose's Report was published in order to reserve a position should his Report not address what were then perceived to be crucially important matters. Accountants Burgess Hodgson likewise reserved a position on historical overbonusing on behalf of EMAG over the years 1990-2000. Later criticisms of hindsight were thus obviated, such that full authority to point out and explain any subsequent deficiencies of note in Lord Penrose's Report would be retained after the event. In view of the way the UK authorities have behaved throughout The Equitable Life scandal, this stratagem has repeatedly proved its worth. In the event Lord Penrose did not make a detailed evaluation of WPWM or its consequences. Had he done so, it is not unreasonable to suppose that the Treasury could not now make the assertions that the Equitable's course of action counts as a routine business decision. So once again a position reserved years earlier suffices to dispel recurrent myth.

(It is not inappropriate also to note here that a further reserved position was made in response to the Parliamentary Ombudsman's draft Report, and carried over with all too little modification as a commentary on the Final Report. In this submission it has been used to authorise the re-introduction of Newton and the approach to serious breach of directives criteria in the EU.)

Section I: London, March 20th 1989

Roy Ranson presented the paper in London[8]. Though more could have been taken from the discussion, the following suffices:

Mr J.H.R. Tonks among others defended the estate principle, and from him the following extracts are pertinent: "Assuming that the fund continues to accept new business, we could endeavour to reach the simplicity of the author's situation by considerably increasing the bonuses paid to the current generation of policyholders. To my mind there are two major objections to this course. First, it is inequitable to pay the present generation considerably more than they have earned. Secondly, if bonuses are artificially increased in this way the fund will attract more new with-profits business and so hasten the time when bonus distribution returns to normality. At that time the new policyholders will become disenchanted with the situation, because they have received less than their expectation. Thus I believe that, in practice, the estate will continue in being for the foreseeable future." This is, of course, a considerable understatement of what eventually materialised. He concluded: "A fifth item needs to be added to the information to be provided for a policyholder as set out in § 4.3.6. This is the relative size of the estate of the office which he is contemplating joining. That is not to say that the policyholder would always place his business with the office with the highest relative estate, and I accept that there are many policyholders who would prefer an office with no estate, once they were able to understand that such an office's bonus philosophy is in line with the authors', in that it has paid full asset share in the past and proposes to do so on future claims. Other policyholders may prefer to join an office which has a safety net of an estate, even if they realise that this has been built up by paying less than asset shares in the past, which could indicate a similar policy in future. *Whatever the outcome, I believe that they should have this information, and that it is our duty to them to devise some means of doing it."*

Mr C.S.S. Lyon reiterated the value and functions of the components of a traditional estate, as did G.K. Aslet who followed him, e.g. "…It does not seem to be difficult to explain that a mutual life office has an existence apart from the interest of those who happen to form the current generation of policyholders. This was surely the intention of the office's founders. To do otherwise seems to invite the opportunistic argument that the office should be wound up immediately so that its riches can be distributed among its members. Such a course would not appeal to those who need insurance and not a windfall profit." –and again: "… The authors also criticise the current emphasis placed on office strength, and I realise that this is fashionable. I do not want to imply that any single ratio can adequately describe the characteristics of a life office, *but its strength does have virtues beyond that of preventing the DTI intervening in an office's affairs, and there are many policyholders who might wish that their advisers had paid more attention to this point when recommending their policies.* A strong office has greater freedom to adopt the investment policy it believes will be most profitable in the long run and thus most beneficial to its policyholders. Such an office also has more time to adjust to changed conditions before being forced to take action." Again with hindsight this looks like an understatement.

Mr H.W. Froggatt concisely and efficiently summarised the issues surrounding an intrinsic mismatch of risk and reward

for the different categories of policyholder in relation to the investment mix held. He began by saying that guarantees cost money, and one could meet this by appropriate charges, and/or by reducing their impact by holding a suitable proportion of fixed interest securities. The latter is also particularly important if there is no reserve estate, and so it is in the event doubly unfortunate to the extent that, in the scramble for higher overall returns, it may later have been neglected (see R. & H. section 3.2.7 & 3.2.8). H.W. Froggatt continued: "...So, for the authors' office, it seems that the total guarantees are catered for by adjusting the aggregate investment portfolio. The office, as a whole, holds investments appropriate to its guaranteed liabilities. It also exercises some control by adjusting the reversionary bonus rates. In neither case is account taken of the very different levels of guarantee being provided for policies of different original and outstanding term; nor for policies of different classes. In effect their policyholders are charged the same for guarantees regardless of the level of guarantee which applies to their policies at the time. This can leave room for selection against the with-profits policyholder in some circumstances.

Insurance operates by pooling homogeneous risks. If risks are significantly heterogeneous there comes a point at which it becomes worthwhile to distinguish the different levels of risk and to underwrite and to charge different rates of premium for them. In the context of asset allocation for with-profits business, the relevant risk element is the investment guarantee. So it is appropriate to ask at what level of guarantee it is worthwhile to abandon the simplicity of the authors and differentiate between policies with different levels of guarantee?"

And in his conclusion he stated*: "The simplicity described in this paper has its price; and existing and new policyholders- and their advisers, if they have any- ought, in the present climate of disclosure, to be made aware of what these might be".*

Section II: Edinburgh, 19th February 1990

The Ranson-Headdon paper had a second outing the following year on the 19th February at the Faculty of Actuaries in Edinburgh[10]. In introducing it Christopher Headdon took the opportunity to explain the latest developments, and to attempt to dissuade the meeting from discussing the estate issue in so much depth as previously in London. He began by saying that at the end of 1989 the market value of the Fund assets stood at around £5,700 million and that after the transfer of appreciation to revenue to support the bonus declaration the "investment reserve" amounted to about £1000 million. How much of the latter was accrued unconsolidated benefits and how much was remnants of the previous estate was not explained. Significantly, he went on to say that a further development to the bonus system had been made: "Paragraph 3.2.18 of the paper foresees the development of the business so that total policy proceeds, that is the sum of consolidated and unconsolidated benefits, steadily accumulates from year to year in a way which would enable published final bonus scales to be done away with. Such an approach is consistent with our general philosophy in that we consider all business of whatever term or duration in force to experience the same uniform asset mix.

At the time of writing, we had seen this development of our bonus systems as a possibly long-term development. However, circumstances have changed, and we find it desirable to make such a move sooner rather than later. Accordingly, the new approach was introduced in respect of 1989." And a little later: "Our recurrent single premium business is, effectively, equivalent to unitised with-profits business. Since most unitised with-profits business is fairly new, the terminal bonus element in policy proceeds is not yet very significant, and most offices appear to be taking a fairly straightforward approach to this part of total proceeds.

By contrast, we have been selling such business since 1956, and have substantial tranches of business which have been in force long enough to have attracted a sizeable final bonus element. Arriving at an approach which deals with the unconsolidated element of total benefits in an equitable manner, in the face of a very wide degree of variability in the timing and amount of premium payments, is, we feel, a problem which we have encountered in advance of most offices. It would be interesting to learn if actuaries with offices now writing unitised with-profits business have different ideas of how to cope with terminal bonuses when the business becomes more mature." All too evidently the Equitable never solved this problem either, and ended up with unreal bonuses that crossed over into genuine liabilities.

Headdon then went on to say that there was not one myth of estate, but two: "The first myth is that all offices have an estate, in the sense of a body of assets which belongs to no-one……….. The second myth is that by having an estate, an office's policyholders are much better prepared than if no estate exists. If one has an estate, then it seems to us that one of two approaches can be taken. The first is that the estate really is a cushion that is available if the need arises. The second is that it is money held in a kind of trust, to be maintained and passed on to future generations.

If the first of those approaches is taken, then additional protection is available on a one-off basis for one fortunate generation of policyholders. However, once used, the estate ceases to exist and the office moves to our position.

In the second case, the estate cannot be utilised except for some temporary additional smoothing, since it would otherwise not be preserved for the future. In that case, are policyholders really better protected? Indeed, should not product particulars state that the office's policy is to maintain an estate of x% of assets, and that a charge of y% on the investment earnings otherwise available to policyholders will be made in order to support that policy". The sophistry in this passage is so obvious that it needs no formal explanation, and in the underlined portion Headdon has begged the question as to how the Equitable's own approach should have been put to its representatives and policyholders. In the

event, of course, that explanation never materialised.

In opening the discussion Mr S.T. Meldrum said: “The paper is not a rigorous mathematical proof of a new actuarial principle. It is a clear and straightforward description of a bonus philosophy tinged with pragmatism. We must thank the authors etc”. He also declared a natural sympathy with the approach taken in the paper, because he had qualified at the Equitable. His position was therefore more informed than most, and he stated it thus: “The authors in paragraph 1.1.1 find themselves frustrated at industry obfuscation in the form of resistance to un-bundling of expenses and an emphasis on “strength”. They find their escape in borrowing some of the concepts of unit-linked insurance and applying them to the with-profits contract and in particular to one form of that which makes up the bulk of their office’s business, a form of recurring single premium with-profits pension accumulation policy.

Each premium paid secures a slice of the fund calculated by accumulating the premium less expenses at a guaranteed accumulation rate of 3.5% (i.e. the Guaranteed Interest Rate or GIR) to the chosen pension date. Effectively this is the “sum assured” of the policy. Reversionary and terminal bonuses are declared on this sum assured with the intention of returning full value to the policyholder at his pension date, but with a “smoothed” investment return.

<u>Since 1987 results have been shown to policyholders additionally in present value form and for new contracts such as personal pensions this is the only form.</u> The contract is then effectively a unitised with-profit. The authors in paragraph 3.2.6 define the policyholders key concern in bonus declaration as the total proceeds with the question as to how much can be declared and how much to emerge as terminal bonus as of secondary importance. The increasing guarantee given by declared reversionary bonuses is however central to with-profits business.

In paragraph 3.2.15 the authors describe how the final bonus lifts the declared bonus to an appropriate asset share subject to averaging and smoothing. The smoothing occurs two ways: firstly over durations at that point in time, and secondly over time.

The essence of smoothing is insurance of the investment risk. It is a system which has inherent appeal but I have some practical difficulty with its application.

My first problem relates to the smoothing over time of an investment risk whose first move is downwards. It does not appear possible to do this within the ordinary understanding of prudence unless there is some other source of capital available. This appears to have been the situation described in Appendix A for the triennium ending 31 December 1976. The situation was then met by releasing unnecessary margins in the valuation basis. It is in this sense that I describe the approach in this paper as one of pragmatism rather than one of rigorously proven theory.

It is in the area of policyholder’s self insurance of investment risk that I believe a lot more could be done to make the techniques more scientific. A life company can self-insure mortality risks with the experience, good or bad, reflected in the returns to with-profit policyholders. But to do so it must have some measure of the expected risk to be charged initially to each policyholder and on the basis of which the subsequent experience is then spread. This is the principle of equitable assurances. I cannot see a corresponding principle of equitable investments described here.

How sure are the authors that the averaging over contracts fully reflects the risks of those contracts? How sure are the authors in averaging over time of where the market then stands? Hindsight is a great help, but without it the consensus of all the players in the market is that the next move is as likely to be down as up. The market reflects all that is known. I would like to hear more on how the authors improve on this.

The process of an increasing level of guarantees under each policy as bonuses are declared while the totality of policies still participates in the investments underlying the whole fund is one whose pricing basis lies in option pricing theory… Although the practical difficulties may be large I recommend that some thought be given to this because it is in this area that I am least comfortable” Here S.T. Meldrum seems to be making much the same points as H.W. Froggatt had previously, although starting from the analysis of risk rather than from guarantee. The underlined portion is now important in terms of what should have been disclosed in view of how matters were actually represented, as well as to whom.

Also relevant to issues of disclosure was his conclusion: “The authors have done us a great service in exposing these issues and there is a lot of material here which those present can use to compare with the philosophy of their own offices. I would like to think that more offices would be encouraged to expose their philosophy in this manner. *I look forward at least to reading a mini version in the many company booklets which are shortly to be produced”.*

Mr P. Kilgour provided a comprehensive and well-balanced overview of the situation. The following extract from his commentary is relevant to the vexed question of guaranteed versus unconsolidated benefits, and what the corresponding duties of information might be: “ The authors suggest that with-profits policyholders expect to receive policy proceeds on maturity broadly equal to those that would have been achieved under a unit-linked contract invested in a balanced managed fund. *I wonder whether all policyholders would agree on the investment mix in a balanced managed fund. A lack of clarity about the target at which they think their with-profits contract is aiming is likely to result in confusion.*

The balanced managed fund against which they should be comparing is one which is appropriate given the guarantees in the contract, and any attempt to describe an appropriate portfolio of investments for a with-profits contract must include a comment on the relevance of the guarantees.

The significance of these guarantees is substantially reduced if declared bonus rates are at a level financed by only a fraction of the full investment return being achieved. The authors do not say so but I wonder if they are suggesting that in future, policyholders can expect that, whether there is inflation or not, declared bonuses will be at a level financed by a fraction of the investment return achieved- thereby creating a continuance of the current picture for maturities in that a substantial element of the maturity payout will be in the form of a terminal bonus. This seems in concert with their claim that with-profits business is a source of capital- in fact I do not see how it is unless such a bonus policy is pursued.

The forthcoming statements on bonus philosophy will probably contain a relatively detailed explanation of a company's current stance but will not tie the company to a continuation of that stance. Over the duration of their contracts, policyholders will be able to gain access to up to date statements on bonus philosophy and will be free to make their views known to the appropriate parties should any changes not meet with their approval." To this one can only say: "Amen, and if only!" Mr Kilgour also supported the role and value of a "dowry" or estate in the usual ways, and explained his own preferences for adopting an appropriate investment mix based on duration elapsed and term to run, and which also reflected the level of guarantees.

Mr W.B. McBride spoke as one whose office had strong parallels with the authors' as a non-commission paying mutual, the major part of whose business was also single premium with-profits, which had been growing rapidly in recent years. However he continued:

"Our trading experience, however, as is public knowledge, has been rather different.

Again until recently, my office would probably have subscribed, although more subconsciously than the authors, to their view of the mythical nature of the rationale of the estate, even of its existence.

We would not hold that view today. Instead, we recognise the estate as a precious attribute of the office, inherited from the past, yes, but to be husbanded, and handed on to future generations of with-profits policyholders. We would recognise the estate as the difference between the value of the assets and of the published liabilities, plus the present value, at the required rate of return, of the future stream of profits from the business (other than profit attributable to policyholders). This measurement should reconcile with the difference between the value of the assets and the total of the asset shares of current policyholders.

We would not consider the fact that various methods of making these measurements exist, so that the size of the estate at any moment is not an absolute and precisely measurable quantum, as any barrier to accepting its reality. As to its rationale, our experiences have reinforced the view, held by many actuaries, that the estate is of benefit to the current generation of policyholders in a number of ways, notably the power it conveys to the office to smooth out the effect of fluctuations in the equity markets.

Given that shares now change hands every hour of the 24 somewhere in the world, and that there is instantaneous reaction to news good or bad, smoothing power has never been more important.

Where there is no estate, and the investment reserve represents the unconsolidated earnings attributable to current policyholders, one would expect terminal bonus rates to be rather more volatile than I believe has been evident in the declarations by the office of the authors. I immediately dismiss as unworthy the suspicion that perhaps they do not know their own office's strength …….

…..We do not claim that our asset share calculations represent precise reality- they could not hope to in practice and ought not to in theory, or the process reduces to unit linking- but we believe that their relativity to one another is valid. The process implies, of course, a significant degree of smoothing which has recently been made practicable again for us by virtue of becoming backed as a sub-fund of an international mutual, by a powerful estate." The omitted intervening section echoed previous observations on risk, liability, asset matching and bonus distribution philosophy. Alas, the underlined statement proved all too worthy in the event; the only argument now being over how much was hubristic ignorance and how much was concealment.

Mr C.E. Barton agreed with the authors over the estate issue, but may have been mistaken in observing: "I very much like the author's preference for the term "non-consolidated assets" rather than the somewhat mysterious term "the estate". When Redington coined the word "estate" in 1952 he was much more concerned with solvency than with the equitable management of a participating fund. Twenty nine years later, against the background of "The Flock and the Sheep", Redington's concern was with "non-consolidated assets" rather than what has been called an "inviolate estate"". Did he realise that this included the liability estate, or that the "asset estate" might come to exist only in notional form as unconsolidated and unsupported bonus statements?

Mr M.D. Ross was under no such illusions. He said: "There is very much in the paper with which I agree and which reflects my own views on bonus policy. However, there are some points brought out in the paper with which I disagree; I think they are based on what I would term as too serene a view of what future conditions might bring…

…Recognition must be given to the likelihood, at some time or another, that the underlying pro rata asset shares will fall below guaranteed payouts and some charge must be retained for this- logically it would vary with policy term.

While reference is made to the pooling of investment mix I do not see this point emphasised in the paper. I see it as important, very important unless the non-guaranteed element can be set very high- perhaps at levels currently applying for long-term policies. However, as I have said on other occasions, it is rather difficult to see such high targets reflected in current reversionary bonus declarations/unitised with-profits price increases.

This leads me on to the section entitled "the myth of the estate." Having done stochastic modelling it is not difficult to see the need for some free assets, certainly with the current valuation regulations. Of course the authors refer to the unconsolidated element of policyholders' asset shares as being available to meet finance strains and guarantees. However again the average duration of an office's business is important and an office's ability to keep the unconsolidated element alone high enough at all times to guarantee survival in a wide range of financial conditions has to be challenged. **Free assets are likely to be required over and above the unconsolidated bonus element…..**

…In paragraph 3.3.5 reference is made to the nature of the guarantees and its relevance in the context of product design. Examples are given of full value guarantees at a range of retirement ages, e.g. 50 to 75. Interpretation of Regulation 62 (2) in its strictest sense is likely to prove very severe in terms of reserving requirements over time, again stochastic modelling is likely to indicate that an office could not demonstrate statutory solvency over time without very considerable free assets- yet the authors eschew the need for this. Something must be wrong. It may be that it is envisaged that the terminal bonus element will always be maintained at a very high level, but of course in these circumstances the granting of a full value guarantee is not particularly meaningful. I raise this, not particularly to take issue with the authors, but more because we have found in our own modelling that a strict interpretation of Regulation 62 (2) can prove very severe for pension contracts. I would be interested to know whether any other Appointed Actuaries would assume all policyholders within the guarantee period would retire immediately or if, what I would call, a more realistic view of this can be taken in practice." Mr Ross was right; something was indeed wrong.

More could be quoted from these discussions, for example the contributions from A.D. Shedden, W.A.B. Scott, and A. Eastwood. Scott, who gave qualified support to the authors' concept of the myth of the estate provided that adequate financial strength was otherwise maintained, also entered the following caveat:

"I think we can agree that it is this modified version of the managed fund concept which has to be communicated to policyholders if the mystery of with-profits business is to be dispelled. On this front the authors may be ahead of most of us, assisted no doubt by the simple nature of the majority of their contracts and by the absence of intermediaries in their dealings with policyholders. Clearly there must be a risk of raising unreasonable expectations if communication of this nature is not carried out with due care and attention but on balance I am sure that this is the road down which we must go"

In view of subsequent events, this opinion suitably concludes the Appendix.