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Mr S Bor
The Office of Sir John Chadwick
One Essex Court
London
EC4Y 9AR

6 November 2009

Dear Simon

Equitable Life ex gratia payment scheme – ELTA comments on my Interim Report

Thank you for your letter dated 30 October 2009 and I look forward to meeting you again on 12th November. I am writing in advance of that meeting in respect of the issues raised and further in respect of the issue of apportionment (as set out in my earlier e-mail).

I apologise for the delay in sending this document to you and which started out as a simple 2 page response and now seems to have expanded to 18 pages. Which on reflection is extraordinary but I came to the conclusion that the response regarding Lord Penrose's report required substantive evidence.

Kind regards and yours sincerely

Peter Scawen

Equitable Life ex gratia payment scheme

ELTA response to Sir John Chadwick's letter of 30th October 2009

1) I note the position in respect of the data prior to the notional start date.

2) I consider the principal issue here is that the "full and fair distribution policy" is being used as a shorthand for the absence of an estate or the absence of a smoothing fund. The Society's literature always stated that there would be smoothing and by natural implication, this means the presence of an estate.

If I may quote from:

i) the Society's With-Profits and Unit-Linked Annuities Guide:

> "The returns from the underlying assets are smoothed out over the years thus avoiding the fluctuations normally associated with such assets."

ii) the Society's With-Profits Guide:

> "The essential feature of with-profits business is that it smoothes out fluctuations in earnings and asset values which are generally associated with investment in such portfolios."

iii) My own annuity contract:

> "With profits contracts have the essential feature of smoothing out fluctuations in earnings and asset values - thereby reducing the effect of **severe** movements in stock market prices" (Emphasis mine of course!)

Of course, these statements are inconsistent with a "full distribution policy", as it is now known to have been implemented, because the maladministration of the Society's regulation meant the absence of any (or any sufficient) smoothing fund. Indeed, based on Mr Josephs' submission to you, the Society actually operated with a negative reserve for many years.

This is despite the fact that as I see it the Society's statements on its contract with me specifically exclude the idea of "full distribution" in the sense that it is being interpreted by Sir John.

It is insufficient to state that the "full distribution policy" was widely advertised without explicitly stating the source of the assertion. Lord Penrose made this statement but so far I have been unable to find the source material for his assertion. I have annexed:

i) copies of posts on TMF, which I consider to be germane.

ii) the text of an e-mail from Paul Chapman in that regard after he and his staff at Clarke Willmott reviewed its Product Literature library and the Penrose "full distribution" references

iii) Extracts from the minutes of the meeting between Lord Penrose and the Treasury select committee very kindly sent to me by Mr M Josephs

I know that Sir John has received a number of submissions from policyholders on this point already, the majority saying that they did not know of such a policy and where they were aware that they did not understand it to mean that there would be no reserves – the policy the Society actually followed. In addition, may I refer Sir John to the e-mails sent by Mrs Pursglove and Maurice Coleman on this topic. I think the e-mail sent by Mr Oglethorpe of some interest as he sets out his beliefs on this matter and also shows how the two assertions of Full Distribution and Smoothing Policy might be reconciled.

So at best, it was advertised in a totally inconsistent and confusing manner and it was certainly not advertised as it was in fact implemented and allowed to be implemented as a result of the maladministration which in fact has taken place.

I would point out that a number of sales representatives have subsequently confirmed that they did not understand that Equitable's financial model was as it subsequently proved to be – for instance the first hand evidence of Richard Lloyd to the European Parliament where he emphasises the trust in the Society's actuaries and the belief that all policy values were covered by existing assets.

Indeed, I am aware that Equitable sales representatives have pursued the Society as a result of policies that they themselves purchased and did so upon the basis of the mis-communication of the Society's financial model to them. If the sales representatives did not understand the "full distribution policy" as Sir John seeks to define it, how can it possibly be said that the policyholders did so because it was "widely advertised".

Whilst I have substantial anecdotal evidence of how the Society's financial model was in fact understood by policyholders, which was that it was subject to a sufficient estate to allow smoothing to take place, it is clearly a contentious point.

So and assuming you are not satisfied with this submission then if any reliance is to be based on this issue then a quick survey of ELTA members should easily clarify the situation. I would be happy to organise this for Sir John providing the costs of the postage etc are covered.

The basic questions are:

i) Was such a policy widely advertised; and

ii) If it was then how was it understood by policyholders?

Next, I wish to refer to paragraph 2.46 in Sir John's Interim Report. First, may I ask Sir John to forgive that somehow I missed this important paragraph in my earlier submission and belatedly I add my comments.

> I think the statement *"This fact was known to all policyholders, or would have been known to any who made the most rudimentary inquiry into the life assurance industry"* simply does not stand up to scrutiny as must now be surely evident from the preceding comments, not least that the contractual documents between the Society and the policyholders appear not to include any reference. It surely cannot be reasonable for policyholders to look beyond the Society's publicity material and contractual documents.
>
> Sir John goes on to state that: *"In creating a model based on data from other life offices, it seems to me that it may be appropriate to assume that the comparator would have adopted a similar policy of full distribution"*. In part I have dealt with this issue by arguing that the only logical comparator for the WP Annuitants in any event is the Prudential – I note in passing that Mr Forfar seems to agree with me on this point in his submission to Sir John – but since no other life office practiced a policy of full distribution, I cannot see how such an adjustment is practical.
>
> Finally, Sir John states that: *"I currently take the view that if a life office were to operate a policy of full distribution responsibly, it would adopt a conservative approach to investments. That would be reflected in the assumptions to be made as to yield and growth of the fund."* Well that is not what the Society says in its literature in my possession. I quote from the document **Equitable Pension Annuities:** *"The Society's With-Profits fund effectively provides the opportunity for investment in an actively managed and wide ranging portfolio of assets covering fixed interest securities, equities*

and property". I may be wrong but that does not read like a "conservative approach". Nor does Sir John's conclusion follow from his premise. It depends entirely on the valuation interest rate used by the Appointed Actuary. Had the Society used a rate close to zero as befitted the business it had written, there would have been ample assets to support the business and the occasional (and expected) market downturn.

Self-evidently if as Sir John states that *"a life office were to operate a policy of full distribution responsibly, it would adopt a conservative approach to investments",* then whatever the Society did or did not do, it did not work - as clearly the Society failed. One must conclude that the Society did not adopt a conservative approach or an appropriate valuation rate, things that logically should have been known to the regulator, who in turn failed in their duty to ensure that the Society's investment strategy was consistent with its duty to its policyholders, an investment strategy and regulatory failure that led inevitably to the collapse of the Society. We must not forget that the Society remains unique amongst UK life offices in this failure.

In response to the other queries, then:

ii) It is self-evident that a policy with a sufficient fund for "smoothing" could have been successfully maintained and one without could not. The Society failed as a result of this very element.

(iii) A sufficient estate would have been necessary – as in fact implemented by Prudential – my suggested comparator.

(iv) The "full and fair distribution policy" as implemented was allowed to continue, when it should have been spotted, as a result of the maladministration which took place. This reinforces my position that no adjustment should be made for any "notional business model" and a direct comparison with the Prudential undertaken.

Sir John has referred to the passages appended to my submission. These passages were in fact appended because they were the ones referred to in your e-mail to me. My point was and remains that these passages are all well and good but they are totally inconsistent with the message communicated to and understood by the policyholders. This is explored in more detail in the enclosed text of the e-mail from Clarke Willmott.

My intention and I apologise if this was not clear was that if one reads the entire set of paragraphs starting on page 8 "Turning to the issue …." and finishing half way down on page 9 "…..assessing ex-gratia payments", then as I say and I paraphrase, if the professionals cannot agree amongst themselves what their understanding of what was actually taking place, it is unreasonable to base an ex-gratia payment scheme on the presumption that policyholders did so understand especially if it is based on the fiction that it was "widely advertised".

The mere fact that the "full distribution policy" appears in statements of intended approach does not mean that the Society's actual financial model as in fact implemented was understood by policyholders for the very reasons that I have already highlighted above.

3. Of course, if you are to estimate future income returns as at 31 December 2007, the most accurate way to do that is to apply the actual returns which have been received between that date and the date of the calculation. Otherwise you are in the rather odd position of making notional future assumptions but adjusting those assumptions for the actual experience. Of course, if the latter step is undertaken accurately, there should be no difference in the actual result but it seems an unnecessary complication to take that step rather than shift the date on which actual data is used and save notional future assumptions for the future.

<u>Apportionment</u>

I have read the Law Commission's proposals and I have had the advantage of considering Michael Joseph's comments on this issue.

I echo the points that he has made relating to *ex gratia payment schemes* and current Treasury guidelines, the ordinary principles of Joint and Several Liability and the ordinary compensatory principles and the need to restore individuals to the position that they would have been in but for the maladministration. I also echo his points regarding the seriousness of the failures and the lengthy period of time over which the failures took place.

However, to me, the most compelling element is simply the overall justice of the position. Policyholders were fundamentally reliant upon the proper regulation of the Society. Their alternative positions properly regulated are easily ascertained and calculated. They have no other routes available to them for the balance of any compensation notionally reduced. Indeed, the Financial Ombudsman Service dismissed en masse complaints based on the Society's financial position so many will have attempted such redress but have been thwarted by the institution set up to protect their interests.

It would be entirely inappropriate to attempt to implement future recommendations let alone proposals from a discussion document as to a future approach when this would result in individuals being left without any alternative remedy to recover the balance of their losses (and their losses which but for the maladministration would not have occurred). This would in essence be a notional reduction in an arbitrary manner.

Accordingly, my study of the Law Commission document and Michael Joseph's comments has reinforced my views that the justice of the situation demands that no apportionment is made to the losses. I cannot see that this is a situation where two different parties are partly to blame. It is a situation where Equitable's management performed in a manner which it should have been prevented from doing by the regulator and if the regulator had exercised its function properly, the comparative losses against say performance under an alternative Prudential policy would not have occurred.

Yours sincerely

Peter Scawen

Recent Posts on TMF slightly edited.

Author: hectorajg 

Subject: Full distribution

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Recommendations: 25

As citymj points out:-

http://boards.fool.co.uk/Message.asp?mid=11729066

Even today the Government continues to argue that policyholders willingly accepted a high risk business strategy and therefore should themselves shoulder much of the loss. [See Chadwick's Interim Report.] Is this so, or were we deliberately deceived about the financial strength of the WP Fund? I say that we were deliberately deceived and that the story we were told was a dishonest one.

The relevant part of Chadwick is as below:-

One major consideration that I have identified is whether the appropriate comparator should be modelled by reference to the best, median or most poorly performing life offices over the period. This consideration is likely to be influenced by the fact that Equitable Life's business was carried on pursuant to a policy of full distribution. ***This fact was known to all policyholders, or would have been known to any who made the most rudimentary inquiry into the life assurance industry.*** *In creating a model based on data from other life offices, it seems to me that it may be appropriate to assume that the comparator would have adopted a similar policy of full distribution. I currently take the view that if a life office were to operate a policy of full distribution responsibly, it would adopt a conservative approach to investments. That would be reflected in the assumptions to be made as to yield and growth of the fund. I invite comment on these points.*

My own view is that I suspect that few policyholders knew that Equitable operated a unique policy of full distribution **in the absence of an estate**, i.e. they knew nothing about Equitable's unique business model. They assumed simply that Equitable was a WP fund in which assets matched liabilities and in which there was an appropriate smoothing policy.

This conclusion is IMHO supported by the findings of the Institute of Actuaries Disciplinary Committee against Roy Ranson:-

http://www.emag.org.uk/documents/tribunal_rep_elas_summary.p...

The charge:-

As the appointed actuary, and as managing director and actuary, Mr Ranson was charged with failing to: -

Identify and/or monitor and/or manage the risks that the Society was running which cumulatively led to the Society being weakened and unable to meet the reasonable expectation of policyholders and alleged failure adequately to notify the Society's board of such risks

The Determination:-

The panel found that in implementing the stated philosophy of providing a full and fair return to policyholders, holding no estate apart from a revolving estate providing working capital, and

treating policyholders as participating in a managed fund, Mr Ranson, over a long period of time:-

• consistently failed to apply an appropriate smoothing policy
• failed to provide appropriate information to the Society's board to enable proper consideration to be given to the consequences of his recommendations
• failed to maintain the publicised relationship between the investment reserve and total policy values notified annually to policyholders.

Thus even if there was a policy of full distribution that "was known to all policyholders" (as Chadwick asserts), it is impossible to ignore the fact that the Institute of Actuaries put this rather differently - as a policy of full **and fair** distribution, the additional phrase "and fair" being IMHO absolutely critical!

citymj asserts that "We were deliberately deceived and that the story we were told was a dishonest one".

If folk wish to argue otherwise, they have to find an explanation as to why Ranson made so many "errors", only a few of which are summarised here.

This (the policy of full distribution) is an issue that merits discussion here now not what might have happened in the past.

Author: oldmalthouse 

Number: 80425 of 80507

Subject: Re: Full distribution

Date: 1/11/09 21:33

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Recommendations: 16

hectorajg in post 80424

My own view is that I suspect that few policyholders knew that Equitable operated a unique policy of full distribution in the absence of an estate, i.e. they knew nothing about Equitable's unique business model. They assumed simply that Equitable was a WP fund in which assets matched liabilities and in which there was an appropriate smoothing policy.

I would agree with this statement, because this is what the Reps told me.

I specifically remember a meeting with an Equitable rep (Roy Johnson) in Sept 1997 when I suggested that I change from the WP fund into Unit Link funds. He strongly advised me NOT to do this stating: " If you are in Unit Link funds and there is a 30% fall in the stock market at the time you wish to retire, then you will suffer a 30% fall in pension income. However, if you remain in the wp fund, and there is a 30% fall at retirement time, then because of the WP smoothing then not only will you not suffer a cut in fund value, but the reserves will still pay a bonus. (keeping back some of the bonus made in the good years).

Like a fool I believed him!

cheers

Author: noglethorpe 

Number: 80426 of 80507

Subject: Re: Full distribution

Date: 1/11/09 21:57

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Recommendations: 15

80425 "I would agree with this statetment, because this is what the Reps told me.

I specifically remember a meeting with an Equitable rep (Roy Johnson) in Sept 1997 when I suggested that I change from the wp fund into Unit Link funds. He strongly advised me NOT to do this stating: " If you are in Unit Link funds and there is a 30% fall in the stock market at the time you wish to retire, then you will suffer a 30% fall in pension income. However, if you remain in the wp fund, and there is a 30% fall at retirement time, then because of the wp smoothing then not only will you not suffer a cut in fund value, but the reserves will still pay a bonus. (keeping back some of the bonus made in the good years).
Like a fool I believed him!"
==========

I strongly advise you to write to Sir John and TELL HIM this. He has appeared to believe that Equitable's "Full and Fair" distibution was not only known to, but was also understood by, all who went for a WP Annuity.

The habit of running the business for years without the assets to meet its obligations was not disclosed, nor the absence of the smoothing margin which "Full and Fair" would require if it was really to be Full and Fair.

Do please write to Sir John. He may even have believed that what Equitable did WAS Full and Fair, but I am relieved to be able to say that he has been told very clearly how wrong this was.

Author: angerberry **Number:** 80427 of 80507

Subject: Re: Full distribution **Date:** 2/11/09 08:37

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Recommendations: 14

Hectorajq - " They assumed simply that Equitable was a WP fund in which assets matched liabilities and in which there was an appropriate smoothing policy."

Those who purchased an ELAS WP product, be it a WP Bond or the fatally flawed WP annuity, or - as in my case - both, did not "assume" there was a smoothing fund, they were actually TOLD so by the ELAS reps. who sold the products.

Are you saying, noglethorpe, that even at this stage, and having one assumes and hopes looked extensively into matters ELAS, Sir John Chadwick is under the impression that people who took out a WP Annuity KNEW that the priority for THEIR money was the payment of the pensions and GARS of OTHERS?

If this is indeed so, it surely indicates a failure of comprehension at a most fundamental level of what the whole ELAS issue is about?

Author: onethemoorings **Number:** 80428 of 80507

Subject: Re: Full distribution **Date:** 2/11/09 09:48

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Recommendations: 13

My own view is that I suspect that few policyholders knew that Equitable operated a unique policy

of full distribution in the absence of an estate, i.e. they knew nothing about Equitable's unique business model. They assumed simply that Equitable was a WP fund in which assets matched liabilities and in which there was an appropriate smoothing policy.

This appeared to be so because Equitable regulalrly published a table showing the performance of the With-Profits fund and the percentage distributed to policyholders in bonuses. In good investment years this table did not show a full distribution of profits, while in bad investment years it showed a distribution above the level of profits giving the impression that the bonuses in bad years were paid out of a reserve fund of profits were withheld in the good years. Was all of this a fake?

The Equitable WP fund even paid a bonus in the year of the 1987 stockmarket crash

If there had been a criminal investigation into the Equitable case the diretors and the auditors would have hed to explain these matters in court.

Equitable boasted that it had the best IT systems of any company in the business. If these matters had been investigated at the time of its collapse one assumes that this system could have shown very clearly what had been going on and that the same system could have revealed any shortcoming by the auditors

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Author: bienterry **Number:** 80487 of 80507

Subject: Re: Who needs smoothing anyway? **Date:** 4/11/09 09:16

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Recommendations: 4

I would never have bought a with profits annuity if the ELAS Rep had not said there was a smoothening fund. I don't think anybody would. It was a central plank of their marketing strategy. They knew that it was of great importance to pensioners that there were not great fluctuations in their incomes

E-mail from Paul Chapman

From: Paul Chapman

To: Eltaorg

Cc: Robert Morfee ; Jon Green

Sent: Friday, November 06, 2009 7:14 PM

Subject: FULL DISTRIBUTION REFERENCES

Peter

Further to our discussion, I have reviewed the Penrose Report for all references to "full distribution" and additionally considered our Product Literature library for any such references – albeit as you will appreciate, this latter examination could not be totally thorough.

I found no references to "full distribution" (per se) within the Product Literature at all albeit I did of course review documents such as the With-Profits Guide to which I refer below in my comments on the "full distribution" references within the Penrose Report.

There are slightly in excess of 40 references within the Penrose Report to either "full and fair" or "full distribution". The only explicit reference to "full distribution" being mentioned direct to the policyholders to which reference is made is at Chapter 5 paragraph 62 (5/62) where there is a reference to a report to members in 1999.

The vast majority of the references refer to either internal reports, exchanges with Ernst & Young, GAD and HMT, GAD Scrutiny Reports and the like (1/33, 3/73, 3/116, 3/125, 4/127, 9/110, 9/118, 12/122, 12/123, 12/133, 12/146, 12/160, 14/116/146, 16/181, 16/243, 17/64 and 17/139) or general comment (6/25, 6/73, 14/2, 14/11, 14/155, 16/29, 19/68 and 19/97).

This leaves references to more general rather than specific comments which **could** if properly understood as to their effect be references to "full distribution". These references are to a 1990 policyholder letter, two editions of the "With Profits Guide" (31 August 1990 and 1 May 1994) and the 1996 Annual Report and Accounts (4/139, 14/78, 14/85, 14/109, 14/110 and 14/124). These four documents are the only express documents, save for the 1999 report to members referred to above, in which it is claimed that the "full distribution" policy was communicated direct to policyholders.

Even in those four documents, there is no express use of the words "full distribution" and as you have set out in your letter, there are references within those documents to "smoothing" which it is accepted in the Penrose Report itself (as properly understood rather than as implemented) is inconsistent with the "full distribution" approach (19/62).

As a result, I continue to find the suggestion that any comparator model be adjusted to take account of a "full distribution policy" to be extraordinary. My experience is that policyholders did not know, nor could they be expected to know, that a "full distribution" model as now understood was being implemented.

There seems to be a misconception that the opaque references within policyholder documentation should have been understood as they are now understood with 20/20 hindsight and not interpreted in conjunction with the assurances on "smoothing" which carried with them an expectation of sufficient reserves.

Penrose appears to have been lulled into a view that "full distribution" was more widely understood and advertised because of his detailed consideration of internal discussion and debate and discussion and debate with auditors and regulators. That was plainly not the case and I say that from my experience of discussions with policyholders as well as consideration of the **actual** documentation, which was sent to policyholders.

Further, it does seem remarkable that there should be a suggestion of an adjustment to a comparator to implement a policy, which in fact was not even properly understood contemporaneously by the regulators themselves. I remain firmly of the view that

Prudential (without any such adjustment) is the suitable comparator for WPAs if the alternative with-profits annuity provider is considered the appropriate approach.

Regards

Paul Chapman
Partner

Clarke Willmott LLP
1 Georges Square
Bath Street Bristol BS1 6BA

Extracts of Lord Penrose's evidence to Treascom 16 March 2004 (my highlights)

Q583 Chairman: If you could speak up a little bit, please.

Lord Penrose: I am sorry. I will speak up. I did take the view that the best way to understand what happened at Equitable was to examine the story and to try to piece together those bits of evidence and information that appeared to make a significant contribution to what happened. I came to the view, in the course of time, that the Society's financial weakness was explained by actions and transactions that had taken place over a long period of time. I have pointed to the fact that at the end of 1972 the Society was in a position of very considerable financial strength. There had been good capital appreciation, there had been relatively little in the way of appropriation of capital appreciation and the Society's excess funds over its liabilities, which at that time were all guaranteed liabilities—it did not have a terminal bonus or anything of that kind—meant that it was very strong, but, as I think one Member of the Committee may have found, the FSSU Scheme had to disappear: it did not fit with new tax legislation, and the Government's subvention that had made the pension aspect of it up was being withdrawn and the Society opted for a change in the scope of its business for expansion to substitute; and at that stage it became necessary, possibly for the first time, for the Society to become very competitive in the new market that it was targeting. The actuarial staff at the Society developed what still seems to me to have been a prudent and careful approach to the appropriation of capital appreciation to bolster bonus. Unfortunately, the policies were adopted in 1973 and by the end of that year the equity market had collapsed. The collapse continued into 1974 and there was no substantial recovery by 1976. Over that period Equitable pursued a very aggressive market development strategy and used actuarial techniques, which resulted in apparent surplus, to make bonus allocations to its members and the strength of 1972 was dissipated. The Board fought back, as it were, between about 1976 and 1982 and a position of considerable, not equivalent strength but considerable, strength had been re-established by the late autumn 1982. By then the conservative policies that had been followed to build up that strength had meant that in one area the Society was falling behind its competitors, and that was in the allocation of terminal bonus and there was a change of direction. It began in late 1982 and it was completed in 1985. Essentially what happened was that the general and non-technical reserve for future reversionary bonus that had been built up was used to support terminal bonus with the result that the free assets of the Society diminished and by 1986/1987 they were gone. The Society had begun to use—for example, it used an accounting surplus that had been thrown up in 1982 when the accounts for the first time showed market value rather than the sort of amalgam of values that had traditionally been used in life office accounts. The result of that was that by 1987, at the latest, the aggregate policy values that were used as the basis for policy illustrations and forecasts and the rest of it had come to exceed the assets available in the with-profits fund. 1988 was a neutral year: 15.1% earned, 15% allocated. 1989 was a good year, and the Society was able to use 6% of the earnings of that year to cut back on the deficit that had emerged, but there was still a deficit and at the beginning of 1990 the with-profits liabilities, sorry, with-profits aggregate values exceeded the available assets by 5%. 1990, as I think everyone will now know even if they had forgotten before, was an appalling year for the financial industry. There was a huge loss. The technical steps taken in 1974 that resulted in a surplus in that year were used again in 1990. They were not used quite so fully because the regulations had changed and there were limits on what could be done, but the Society effectively created a surplus of £557 million by the introduction of a difference in the interest rates used in two aspects of the calculation of surplus, and that money was effectively allocated as bonus in 1990 and 1991. 1993 and 1994 the position was hauled back a bit until the collapse of the market again in 1994, and the exercise was repeated. Essentially, my findings are that the Society did not again get back to a position of having an excess of assets over the realistic policy values, as, I think, it would now be called, by the time that other problems emerged in the late 1990s. The allocation term I have used, the allocation of bonus and a with-profits fund, does not immediately, of course, reduce the assets available: you require a claim. I think one of the critical findings I have advanced was that a fundamental weakness developed because the inflated policy values came to be reflected in claims values applied at maturity and on other claims. You will have seen that the calculations made say that by the end of 2000 there was a £3 billion shortfall in assets

available as against the aggregate policy values and of that £1.8 billion had come to reflect the excess claims payments. I should explain that just a little. The claims payments, of course, took money out of the fund and not only deprived it of capital at that point but deprived it of the revenue that that capital would produce; so the £1.8 billion reflects both the initial claims value and the loss of revenue to the fund. So that, essentially, is what I think I have set out in this rather long report so far as the Society is concerned. There is a question that you will probably be coming to as to how regulation responded to that, but, if you would like, I can say very briefly-?

Q586 Mr Beard: Also, the question arises: if this was the flag-ship of the industry, the life insurance industry, what was happening in the rest of the fleet? What are the implications of your report for the rest of the life insurance industry?

Lord Penrose: I think the rest of the fleet might dispute the notion that Equitable was the flag-ship. It is very easy to make claims about Equitable's position. I doubt very much that some of the chief executives I have spoken to would acknowledge for one moment that their ships had less capacity than Equitable.

Q587 Mr Beard: Your report also highlighted several myths, as you referred to them, promulgated by the Society about itself throughout the 1980s and 1990s. Do you feel that those myths were deliberately encouraged or did they simply grow out of an absence of firm information to the contrary from the Society?

Lord Penrose: I think they just grew. I do not believe that at any stage people sat down and deliberately set up a false picture. I think these things happen in real life. People come to be convinced by their own propaganda, if you like, and out of that views are formed and developed that it can take a fairly heavy blow to dislodge. I think it was incremental, I think that it would not be deliberate. I think that some of the people who spoke about Equitable would be thoroughly convinced of the accuracy of what they said.

Q588 Mr Beard: You have also described in your report what you call serious omissions in the information which management gave to the Board and policyholders over a prolonged period of time. What conclusion have you reached as to how and why that happened?

Lord Penrose: There are limits to the detail that I can give you in answer to a question of that kind, but I think that the same sort of factors as I discussed a moment ago probably bore upon it. There would be a conviction that the indicators of growth and strength that were relied upon were the valid indicators of growth and strength, and they would be concentrated on to the exclusion perhaps of other factors. I do not have any reason to believe that there was anything in the nature of a conspiracy to deceive. If that existed, I have not uncovered it. I suspect it was accidental.

Q589 Mr Walter: I wonder if I could home in on one part of the management structure and the profession of the actuary within the Society. Mr Ranson and his colleagues produced a paper: *With Profits Without Mystery*. Those of us who have at one stage worked in the life insurance industry rather thought of it as alchemy at times, but the actuarial profession, I think, by 1989 knew exactly what was going on because the management had told them, but they expressed what one might describe as "polite disagreement" with this. Do you think it would be fair to say that the appointed actuary system and the peer review process, which was supposedly in place in the actuarial profession, failed the policyholders in Equitable Life?

Lord Penrose: I do not think that I wish to form and express a view on failure of duty in quite that way. The appointed actuary system, as I suspect, worked extremely well in some cases and over quite long periods of time. A generalisation would be most unfair to appointed actuaries generally, but, of course, they came in all shapes and sizes, and I have pointed out that the information available suggests that at one end of the spectrum there were appointed actuaries who were perhaps relatively insignificant officers of the organisations within which they operated, and at the other end of the spectrum one had appointed actuaries who were

people of very considerable influence and power. It would not be a surprise in society if at some time, given that spread, one found someone who produced results that were not generally acceptable. I do not know that I can go beyond that.

Q590 Mr Walter: Okay. There was an actuarial working party that eventually looked at the guaranteed annuity issue and labelled Equitable's approach as unsound. That was in late 1997. If we can look at Equitable's appointed actuary, would you have expected him to have taken more notice of this conclusion than he seemed to?

Lord Penrose: I do not remember reading the conclusions quite as unequivocally as you have put it. I think that in what may be a typical actuarial exclusion that says something like, "It could be said that it was unsound"—it was not an unequivocal condemnation. The way it was expressed, I think, left it open to interpretation as being perhaps questionable but still within the range of options that an actuary might adopt. So, I am sorry, I do not quite read the report as you have.

Q591 Mr Walter: All right. Perhaps I was putting words into your mouth there. The Corley Committee, which was set up by the actuarial profession to investigate events at Equitable, effectively gave the profession a clean bill of health, including that the profession's guidance notes covered all relevant issues and that Equitable's appointed actuary had followed the guidance notes. Do you agree with that conclusion?

Lord Penrose: No.

Q592 Mr Walter: What does that say about the guidance notes?

Lord Penrose: I think that the actuarial profession have now established under Mr Tom Ross, who is the President of the faculty in Scotland, a Committee to consider the need for, and the scope of, more detailed guidance, a more detailed standard. I think that reflects an appreciation that the guidance in its traditional form, from about 1974 onwards in GN1, later G8 added to it, was that the level of generality did not provide adequate criteria for assessing the performance of actuaries, and the joint professional bodies are responding to that. My own view would be that the guidance was far too general and left far too much to individual judgment. It would not be easy, if possible at all, for a member of the public, reading—I assume a reasonably intelligent, well-informed member of the public reading the guidance in GN1 and GN8—immediately to be able to use that as a basis for the assessment of the performance of actuaries. So I think that there was and remains at the moment a need for much more specific guidance, but, of course, that is now the subject of a remit to another gentleman who will undoubtedly have his own views and Parliament, I have no doubt, will be informed accordingly.

Q593 Mr Walter: I think that is right and that will be the subject, I am sure, of another discussion and debate by this Committee. Can I go on to the question of policyholders' reasonable expectations? The Society seems to have taken a fairly narrow interpretation of that and effectively ignored the concept as it is generally understood. What is your analysis of how this interpretation grew up?

Lord Penrose: When the term was first introduced into the Draft Bill in 1971, or thereabouts, I think there was a very clear understanding of what it meant, and it involved the notion of looking very generally at what a life office did, what it said about its business and asking the question: what would a reasonable policyholder make of this? Not in an extravagant way, but addressing reasonably the question of what is this likely to determine for the future? It became very quickly clear that to police PRE for every one of over 400 offices at that stage would just have been an impossible task, and so there was no effort made to collect information for regulatory purposes in a systematic way over time—there were occasional and partial investigations, but no general attempt to collect the information that was required—and so, in a sense, the test probably, in the words of a Scottish lawyer, fell into desuetude. It simply was not applied—and it did not come into prominence again, so far as I have been able to discover,

until the early '90s when major restructuring was going on within the life industry and when people did begin to consider whether policy holders, as against shareholders, in a typical case had an interest in accumulated non-allocated surpluses, and at that stage there was a fresh look at it. The actuarial profession itself set up yet another working party that came generally to the view that PRE was simply equity, and, as the report put it, of course individual actuaries would have different views of what equity implied and so again one had substituted for statutory language a test that had no very clear content. So I think it was not given the prominence over a long period of time that perhaps was originally intended by Parliament and therefore it ceased to be a practical tool. It is only when one looks at it from the beginning onwards and begins to ask the question what was this all about that the lack of consistent and coherent approach to the assessment of PRE becomes clear.

Q594Mr Cousins: Lord Penrose, the paper that has been referred to: *With profits Without Mystery*, which you perfectly properly give some considerable significance to in your report—would you say that the future strategy of the Society was set out with some clarity in that paper?

Lord Penrose: In many respects it was, and I think if one looks at the discussion appended to the published paper in the proceedings of the Institute in England, first of all, and then in the proceedings in the Faculty of Actuaries in Scotland the following year, it is clear that the implications of the report, of the paper, were understood by actuaries. I am not certain that some of the implications would have been as obvious to someone who was not an actuary. I did, of course, have the benefit of actuarial advice in looking at documents of this kind and cannot pretend that native wit would have instructed me as to all the implications of *With-profits Without Mystery*.

Q595 Mr Cousins: Indeed. Do you think that is something that the auditors should have picked up on, the implications of what was, after all, a clearly set out strategy?

Lord Penrose: I cannot comment on what the auditor ought to have done. That would be an adjudication on the professional practice of the auditor, which is the subject of current litigation. I simply cannot comment on that.

Q596 Mr Cousins: You have made a very important point just then, which is that anyone who studied the strategy of the Society as it was set out in the "With-profits Without Mystery" lecture, seminar, call it what you will, is something that, if you had come across it, you did not have to be an actuary to see the implications. You have just said yourself that native wit would have guided you?

Lord Penrose: With respect, I think I said native wit would not have guided me. If you read paragraph 3.1, the series of paragraphs under 3.1—I am going from recollection now but I think that is where you will find it—there are references there to the Society having to resort a accrued terminal bonus to deal with certain emergency circumstances such as significant changes in the general interest rate climate. I think, with guidance, one can put that bit of information together with other bits of information and understand what was intended. I do not think that even a reasonably well-informed member of the general public who was not an actuary would in reading that material alone be able to form a view as to possible policies for the future management of the fund.

Q597 Mr Cousins: You do refer in your report on a number of occasions to the auditors raising some issues about the internal audit of the Society?

Lord Penrose: Yes, I have set out my understanding of what the auditors knew, as a matter of fact.

Q598 Mr Cousins: You do not comment on whether or not this point should have been pressed?

Lord Penrose: Indeed; because my terms of reference excluded expressly matters that were properly within the framework of litigation, and to say that auditors should have done something implies that there was a standard of duty, that that is understood, that what was done involved some failure to meet that standard of duty. That is not my task, and I really must insist, if I may, that it is not for me to comment on the performance by auditors of their professional duties.

Q599 Mr Cousins: Of course, Lord Penrose, but, as you point out yourself on page 379 of the report, the converse is also true. Can I read out these words to you: "As I have sought to make clear generally, I do not regard this report as a platform for interested parties of any description to make self-justificatory observations related to issues that arise or may arise in other proceedings"?

Lord Penrose: Indeed so.

Q626 Mr Mudie: In your next sentence, I think it is one sentence which preceded the Minister's " the Society was author of its own misfortunes", you seem to say it is not enough in this case to infer from the coincidence of systems deficiencies of loss that one caused or contributed to the other. That, to a layman, appears to imply, especially when you follow it with " the Society was author of its own misfortunes", that the regulatory system's deficiencies did not cause or contribute to the loss?

Lord Penrose: With respect, I do not think that that is the position. I should make it clear, it may be a terrible surprise to you, but I have not yet read the *Hansard* transcript of what the Minister said; I thought I would be better placed to come here without doing so. It is not for me to comment on what was said in Parliament.

Q627 Mr Mudie: Can you explain what you meant by that sentence then?

Lord Penrose: Yes, clearly. If you think of a typical situation in which one person seeks to blame another for a loss that has occurred, the fact of a loss is a factor, the circumstances in which it arose are a factor, but those two alone would not instruct a claim. There would be two things fundamentally missing: one would be a definition of the duty to address the particular situation that was said to be breached; and a judgment on whether what had been done or omitted to be done constituted a breach of that duty. Those two factors are of the essence of causation of loss. Very much a lawyer's point—I am sorry for that—but one cannot possibly step from the fact of loss to responsibility for loss without going through those two gates. Those two gates were not for me. Essentially what I am saying is that it is very easy to slip into a mode of thought that attributes responsibility for loss without a careful examination of the bases on which responsibility can properly be brought home to a person or a group. That is what I am saying.

Q628 Mr Mudie: If you follow it up with ". . . the Society was author of its own misfortunes" you appear to be making a judgment?

L***ord Penrose:*** I thought that is what I tried to set out in my summary, and what I have tried to set out in the report. If one is looking for the *fons et origo* of the problems here, the Society is that.

Q629 Chairman: We will now turn to the Government Actuary's Department, Lord Penrose. You have described the actuaries at GAD as members of an "introspective" and "exclusive financial group", and described the regulatory process at GAD as "complacent" and lacking in robustness. Was the relationship with actuaries in the industry too clubby?

Lord Penrose: Possibly. I think I should make clear, although the focus here is on actuaries, I do not think that this is peculiar to actuaries. For over 40 years I have been a member of the Faculty of Advocates in Edinburgh and through most of my time my professional organisation

had an exclusive right of audience in the Supreme Courts of Scotland. I can tell you that we came to think that was only right and proper.

Q630 Chairman: It has been described sometimes in the Scottish press as "clubby" as well, has it not?

Lord Penrose: Absolutely, and that is the point I want to make. Actuaries in this respect are perhaps not all that dissimilar from other professional groups that have huge privileges associated with the practice of the profession. Having said that, yes, I think inevitably one has a closeness. Where people share esoteric skills of the kind that actuaries have there is perhaps an easier relationship with others of the same persuasion than there is with those who do not have these skills. I think out of that one can get strength; out of it one also can have weakness; but, yes.

Chairman: Thank you very much. We will see what the tabloid writers make of that answer!

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

Lord Penrose: That is so.

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

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

Q633 Norman Lamb: The other crucial point on that paragraph you talk about the failures of the regulatory system being secondary; is it not almost self-evident that failures of regulation will be secondary because it is usually regulation of something that has gone wrong, so the primary cause is usually within the organisation that is being regulated. It is then a question as to whether there has been a failure to come to grips with those failures in the host organisation?

Lord Penrose: Typically that must be so. I suppose exceptionally one could have a situation in which the regulatory failure precipitated a response in industry, where industry was reactive, as it were, to what was understood to be a regulatory stance. Apart from exceptions like that, yes, you must be right.

Q634 Norman Lamb: On the Government Actuary's Department, if I can just quote from your report you say, "Although GAD brought in a more detailed style of scrutiny in the early 1990s, the standards of scrutiny still impress me as complacent, lacking challenge, hesitant in criticism and in following up on any criticism made. This was, indirectly, reflected in a lack of robustness in the regulatory process". You also say, "Successive GAD actuaries did identify relevant issues, but consistently these were not followed through and were allowed to evaporate. No problem was considered so serious that it could not be left until next time". That is a fairly damning criticism of the GAD, is it not?

Lord Penrose: It is the inference I have drawn from studying the position.

Q635 Norman Lamb: Do you think that attitude, that they could always leave it until the next time, reflected a lack of resources, or more simply a reluctance to confront Equitable with the conclusions that they had reached, or a bit of both?

Lord Penrose: I think a bit of both, but I think there is another factor I have identified which is quite important in this context. The regulatory cycle was quite long and, by the time the regulators were called upon to form a view on the one year, another year's returns would be in. So there was an opportunity for the regulated and the regulator, in a sense, to work out a compromise or a settlement before the next year's returns came along. Many of the views of the regulator were probably reflected in changes of practice. That is quite important because it can support drift, rather than clear, positive action.

Q636 Norman Lamb: Nonetheless, the drift was fatal, was it not?

Lord Penrose: Nonetheless, the drift was there to be seen.

Q637 Norman Lamb: If I could quote your report back at you again, you say: "In relation to the chief executive for most of the relevant period, Ranson, regulators accepted a situation in which he came to hold simultaneously the offices of chief executive and appointed actuary despite officials' clear understanding of the unsatisfactory aspects of the situation, no steps were taken effectively to prevent it from coming about". Then you say: "Pickford of GAD and Ranson discussed the question [that is, of Ranson's combined appointment] at an Institute of Actuaries function, and Pickford intervened [with the DTI]. Ranson's appointment was confirmed, and his position thereafter unassailable". Mr Ranson's appointment as chief executive and appointed actuary seems to be yet another case where the regulator had the necessary powers and information to act but did not act. His appointment was finally confirmed in spite of DTI reservations after the intervention of that GAD officer at that function. What is your understanding of why that appointment was permitted? What justification did that GAD officer give to you—it seems extraordinary?

Lord Penrose: I think the explanation is really rather simple, if not terribly satisfactory. The actuary was already appointed actuary and, therefore, had been judged a fit and proper person under the regulatory regime that had applied at the time. In 1994 sound and prudent management came in as a separate and additional test, but it was not there in 1993; and my understanding of the point of principle, as it was put, was that in the appointment at the time of Mr Ranson to the chief executive approach, the only task that had to be met was fit and proper and he was. *Ex hypothesi* fit and proper, holding a job that could only be held by a person who passed that test. That is the technical answer to it.

Q638 Norman Lamb: Finally, the failure of the former official from GAD to return for further questioning, that you talked about earlier, is that in a sense the central area where you have concerns as the inquiry developed, as to the lack of powers to actually pursue that route of investigation because you were left unable to pursue that line of inquiry?

Lord Penrose: I was left unable to get explanations that he might have been able to give about a course of events at a critical time. I would not want to generalise and say that that was the beginning and end of it. It was a particular stage when I think I would have wished to have had his answers to some very specific questions, and I did not get them because he did not come back.

Mr Burns: Excuse me, were you in particular linking the failure of the officer to give evidence to the issue about the dual roles?

Q639 Norman Lamb: I was referring back to Lord Penrose's earlier answers about the frustrations that developed during the inquiry about not having sufficient powers to pursue lines of enquiry. Here we were faced with someone who was refusing to cooperate further.

Lord Penrose: As I sought to make clear earlier, I do not know whether the person would have had a legitimate reason for not turning up even if I had powers. These things happen. As a judge I am frequently confronted by people who do not turn up to give evidence, and bring doctors' lines and

other things to justify it. One simply cannot step from the fact that he did not turn up to make some adverse judgment on it. I do not know.