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April 24th 2010

Advance copy by e-mail.

Dear Sirs,

You may recall my intention to consult my colleagues about the decision to close the Society to new business, and when perhaps more ideally than actually occurred. But before we get into the outcome of that, it is necessary to revisit paragraph 6.4 of your Third Interim Report in connection with the idiosyncrasies of PO2 in more detail. We have also to take into account what Dr Andrew Goudie has said of counterfactual reconstructions generally [1] if we are to make any further suitably rigorous and robust attempts at counterfactualisation ourselves. If early closure arguments fall into this category, then the need for transparent care in the matter should be obvious.

So it is that this letter divides naturally into these three main heads. The sub-paragraphs under each main head are numbered accordingly, and a brief final summary and conclusions follow. As usual the most important conclusions are *italicised.*

1. **Paragraph 6.4 of your Third Interim Report.** In your latest letter to Peter Scawen [2] you have taken care to repeat this paragraph *verbatim,* as you had previously to Dr Goudie and Laurence Emmett has to me. In retrospect I also realise that, although I have previously dismissed its application in a very general way (the text of which is given in 1.2 below), I was so to speak being tried with it again during our April 15th meeting. You will recall that I had but a couple of minutes to read your April 14th letter prior to the meeting, and so did not make the direct connection at the time. That being so, I suspect that I ended up dealing with the "para 6.4" parts of our meeting in relative darkness and somewhat indirectly. It may thus be that I did not handle it sufficiently comprehensively and conclusively for you. Since you have felt the need once again to quote para 6.4 to Peter Scawen just four days later, I must assume that the meeting was not entirely satisfied with my oblique treatment of it. So let us begin by quoting 6.4 again, plus my original brief reply.

1.1 In pages 4 & 5 your April 19th letter to Peter Scawen you relate that para 6.4 was your response to some of the Treasury's submissions, and observed that: *"The goal of regulation is to set limits to the extent to* *which financial institutions may be mismanaged or improvidently run. Where regulation fails, it is proper to attribute to the regulator any losses resulting from the failure to keep mismanagement and improvidence within those limits.* ***But, equally, it would be inappropriate to attribute to the regulator any losses that would have occurred even had there been no regulatory failure; in particular, any losses which result from mismanagement or improvidence <u>within the limits of the regulatory system"</u>*** *(my emboldening and underlining).* We should all respect this particular form of words as having been chosen with due care.

1.2 To this in para 21.2 of my April 7th letter [3] I had made the general reply: *"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."* Onwards now to spell this out in the requisite detail.

1.3 With our recent April 15th meeting in mind, we may begin by looking once again at the idiosyncrasies of the PO2 investigation and report. That meeting did sufficiently well in addressing the nature and effects of causal inversion and economical ruling with regard to the EU Third Life Directives and *Francovich*. It did not, perhaps, do quite as well in detailing the consequences of UK "Procrustean Bed" method of inquiry (as defined in References and Abbreviations or mentioned in para 13.5 of my April 7th letter). For that we have, so to speak, to rummage through the spoil heap of racked bodies and lopped limbs that were thereby distorted or discarded.

1.3.1 I had originally catalogued this metaphorical heap for the PO2 Investigation as related in Appendix 2 of my PO2 critique, and supplemented it thereafter on pages 13-15 the main text [4]. My overall conclusion began with: "*…Suffice it in this narrative to say that the items group into three main categories of adverse findings resulting from reverse arbitrage of the regulators as previously defined"* before continuing: *"These three categories are:*

1.3.2 *An extensive series of devices and comforts taken by the regulators over several years, which helped ELAS to maintain a public position of official solvency.*

1.3.3 *At the prudential/CoB interface, suppressing, discounting and dismissing evidence of scienter, systematic deceit and misrepresentation, and consequent liability. The consequences of this were, and continue to be, both grave and material.*

1.3.4 *In the course of reverse arbitrage, ending up in positions of falseness and ambiguity."*

1.4 Of reverse arbitrage I observed to you on February 8th 2010 [5]:
"*We have previously noted a general absence of linkage to law and statute in UK reports and inquiries, and that it gives rise to flexibilities of almost entirely the wrong sort. Such is the context within which this latest example must be viewed, and in the case of overseas and international policyholders it also has repercussions in EU and International Law. There is the further consideration that, despite repeated requests, there has been no investigation into what underlay mis-selling at the Equitable,*

or more lately prima facie evidence for regulatory misfeasance or malfeasance with particular reference to events at the prudential/CoB interface. In the case of the regulators these matters have been termed "reverse regulatory arbitrage" whereby the regulators can be considered to have operated the statutory framework in a manner contrary to the interests of those they should have protected. Such manipulations, if deftly carried out, do not directly contravene statutes, regulations or guidelines, but nevertheless may be of the utmost gravity.

The strength of supporting evidence for fraudulent mis-selling and extensive use of reverse regulatory arbitrage has long been such that the burden of proof that they did not occur rests with the authorities, and not Equitable victims. It is within this framework that apportionment for mismanagement and mis-selling - whether wrongful or otherwise- should be viewed. Similar considerations arise in consideration of the CoB matters you have introduced prior to the PO's reference period. They have been addressed in connection with your Treasury correspondence, and receive further consideration in Section C below…"

1.5 ***Enough has now been said to make it clear why the series of actuarial manipulations used by Towers Watson in their counterfactual scenarios or re-visited at our April 15th meeting are of a type which fall fairly and squarely within this overall series of devices and comforts.*** If still you doubt it, please look up the chronological references given in the arbitrage listing of the PO2 critique [4]. *In the present context it follows that the Procrustean methods which have led to their being systematically overlooked are no more likely to survive detailed scrutiny in Europe than causal inversion and economical ruling.* And that in turn has clear implications for what more accomplished constitutionalists and internationalists might conclude are within the bounds of reasonable standards of administration in the European as well as the UK arena.

1.6 *It is with these wider considerations in mind that I have previously set aside para 6.4 of IR3, and might now ask you formally to reappraise the matter in the same light*. Even so, should you still wish continue along these lines then the PO's evidential base and Chronology [6] are data permitted to you by the Treasury. Conversely, it will be by that same evidence that any such further conclusions will be judged. *As matters stand, the phrase "…within the limits of the regulatory system…" is too lax; its meaning and bounds will need to be better defined should the reasoning in para 6.4 be taken any further. Meanwhile it remains dangerous ground, and best avoided in its present state of cultivation.*

2. **General counterfactual considerations.** A grand thing it is for us jobbing doctors to have expert psychological colleagues around to tell us how we have or ought to have been thinking all along [1]. It has given me pause first to review my own efforts at forensic reconstruction as time has progressed, and then to consider whatever counterfactual scene setting of my own I might have done. In my "Equitable Assessment" paper [7] I addressed the individual and collective mindset prevailing in essentially feudal institutional, organisational and management hierarchies. Very briefly, the conclusion was that feudal members tended to behave rather like yeomen of all sorts on the one hand or

ambitious courtiers on the other, and so woe betide the sturdy yeoman who found himself at variance with the Court on *pro bono* issues. Conversely, courtiers seeking preferment will indiscriminately espouse any scheme of their powerful seniors, whether hare brained or not. From this backdrop one may assess the individual and collective mindset at work in dysfunctional feudal hierarchies, which is an important factor in sorting out *cui bonis* motivational attribution, and hence the often complex forensic analysis of modern corporate fraud. The general approach was duly carried forward in the narrative section of "Anatomy of a fraud" [8], and I leave it to you to decide how I have thus far used it on the regulatory side of things in the PO2 critique [4].

2.1 I think I have had just one decent go at counterfactualisation, and that too was in the PO2 paper. There I constructed a virtuous rescissionary scenario on the entirely artificial assumption that everything the Society and the regulators together asserted, or knowingly permitted to be asserted, was soundly based, honestly correct and true in fact. The amount of compensation to be awarded followed the extent that what everyone had thereby been led to believe and also thereby been damaged was in fact unsound, dishonest and untrue.

2.2 Dr Goudie has rightly reminded us that factors like personality, moral stance, ambition, motivation and upbringing should be considered at the individual level when attempting counterfactualisations as well as forensic reconstructions [1]. But equally one should consider them relevant at the collective and organisational level, where they function as endemic, environmental or climatic factors. One might name culture, custom, loyalties and affiliations, reporting structures, recognised ethical standards and criteria of competence among these. ***That is also why, having reviewed the entire catalogue of arbitrage and comforts, I had no real option but to conclude that our regulatory culture and attitude were, over that period at least, fundamentally unfit for purpose*****[4].**

2.3 If now we return to what we have learned about reverse regulatory arbitrage, it may be possible to make a further deduction. It is that wheresoever a series of events and actions can be seen to go <u>with</u> the perceived motivational grain of a suspect collective mindset, it is all part and parcel with routine forensic analysis and reconstruction. But if we are to go further, and use these same tools and environmental criteria to say more strictly what <u>ought</u> to have happened as opposed to more loosely and speculatively what <u>might</u> have happened, then we may also have to posit actions which run <u>against</u> the perceived motivational grain of the suspect culture and mindset. In short, we are looking inside the regulatory *milieu* for the likes of ELAS actuary Andrew Soundy, who as Lord Penrose related challenged Headdon and Ranson on the fairness of the GAR differential terminal bonus policy. What would have been necessary for him to have prevailed, rather than to have ended up overruled?

2.4 If, however, one takes a more tolerant view of the prevailing culture and mindset than I do, then it follows that what <u>might</u> with hindsight have been permissible could weigh more heavily in any further consideration of para 6.4. That would, perhaps, require that what might reasonably and allowably have been done does not lie within the perceived purpose and scope of an already dubious and arguably overlarge body of actions [4,6].

3. **Early closure scenarios and counterfactual considerations.** First and foremost, the early closure scenario fits three criteria. They are EQUI's recommendation that policyholders be put back in the situation they would have been had there been no maladministration, the PO's observation that nobody should have invested in ELAS throughout her reference period, and IR3 para 6.4 with appropriate reservations. Your letter to Peter Scawen reintroduced the subject [2], and the end 1991 closure date mentioned there is a year earlier than when we discussed the matter on April 15th. Though the principle of early closure precedes considerations of date, the timing is nevertheless of no small importance. On news of our discussions Michael Josephs has written to say that his forensic data indicate that this should have taken place no later than the end of 1990 [9], whereas my previous analyses, which also partly reflect Lord Penrose's findings and conduct of business matters introduced successively by you and the Treasury, suggest that action should have been taken at the end of the GAR era for all the reasons that surfaced two years later in the WPWM discussions (You now have my abstract of these but the full text is much to be preferred). On first principles the earlier the closure date the better, in which case the beginning of the PO's reference period also merits further consideration. Finally, with counterfactualisation issues and your words in 3.1 below in mind, I asked my colleagues: *"Is the early closure scenario a) appropriate and b) more likely to be even-handedly fair to all classes of policyholder? c) more problem-free than anything that has been proposed hitherto? If not, what are the imperfections and snags, and what tuning, whether fine or coarse, does it require?"* What follows is the result of those deliberations.

3.1 In your recent letter to Peter Scawen [2] you took a different approach to early closure from our April 15th meeting, as follows: *"There is a related, but distinct issue, which (as it seems to me) your representations have not addressed. This is the possibility that at various times the regulator may have been faced with a choice between alternative courses of action each of which had the potential to benefit one class of policyholders (or potential policyholders) at the expense of another class. Take, by way of example, the position in the second half of 1991 (at about the time of the first of the accepted cases of maladministration). If the regulator had taken action to prevent the Society from taking on new business, that course would (with the benefit of hindsight) have avoided relative losses suffered by those who took out policies after that date. But the probability is that, if the Society had closed to new business at or about the end on (sic) 1991, those who had already invested as at that date would have been in a worse position than in which they now are. If the Society had been obliged to invest principally in fixed interest assets during the 1990s, policyholders already invested at the beginning of that period (among whom are included the most elderly WPAs) would not have had the benefit of the substantial gains experienced by equities during the period. It is far from unreasonable to see the issues faced by regulators at the time as presenting a choice between risks to those who were policyholders and those who might become policyholders in the future."*

3.2 With all due respect, one must first suggest that in these circumstances the proper consideration is not hindsight, but the contemporary duties of foresight by any responsibly good shepherd. Under no circumstances should you introduce new sheep into a flock that is already diseased. The primary objective of regulation is prevention, not cure. If that makes for uncomfortable circumstances, then they in turn must be faced. They logically extend to general quarantine and checking that the problem has not spread more widely (as indeed the estate wasting disease already may have, which is one aspect of prolonged pan-regulatory failure- see end of Appendix).

3.2.1 Back now to the main flock, and what happens when you call in the pathologist and the vet. Given what happened after closure when eventually it did occur, we might reasonably suppose that the Parliamentary Ombudsman would have written a Report a decade or so earlier than had eventually transpired, and meanwhile that the Shadow Chancellor of the Exchequeur would have bayed for compensation from the Conservative Government just as he did for the Barlow Clowes victims. It could all have been settled much earlier for a fraction of the any current cost, with a million odd future victims spared. What is more, the impact on the whole UK with-profits industry is likely to have been almost entirely beneficial- but that is admittedly in part a matter of hindsight. What a closed Society might then have done when the GAR later bit is an interesting speculation, but rather than enter into it one might more simply assume that it too would have become a matter for compensation in the normal course of events. *Moreover there would not then have been the same pressure to fudge all the combined deficits under the aegis of the GAR in a Compromise Scheme, with the many dependent injustices and complications which haunt us still.*

3.2.2 With these counterfactual matters in mind, we may proceed to examine the date by which closure should have occurred more closely. *Had the 1987 fraudulent transition from the GAR era been scotched, it might well have proved impossible to finance a ring-fenced non-GAR with-profits sub-fund, in which case closure and run off of the entire with-profits business would have been unavoidable even then.* The only other option would have been refinancing *via* demutualisation, given that the Equitable's previous good name and standing was intact and valuable at that point. It would be instructive to have your advisors' view on this. But as time went on, the worse and steadily more complicated this situation got, and the less realistic demutualisation would have become. At what point, therefore, would a duly diligent prospective purchaser have had to walk away from a demutualisation deal? Surely it would have been long before the *Hyman* final decision! While it may be difficult to say precisely, it would, I think, have had to be before the GAR finally bit for the reasons you may have followed on April 15th. Even before that the price of the GAR option would have been a factor in due diligence, and so the dependent question is by what point it would have been considered excessive. But still the overriding fact remains: An office in overall chronic deficit cannot properly support any reasonable expectations of both the with-profits and assurance elements of its business. *All this persuades me to follow Michael Joseph's advice and plump for the end of the stressfully contentious year of 1990 at the latest. It has the additional advantage of starting the period over which the PO found maladministration with regard to the affordability and sustainability of the Society's bonuses.* I am confident that if you asked for Michael's input here he would willingly assist you even at this late stage.

3.3 If earlier closure was an uncomfortable though worthy prospect, it may well have run contrary to the grain of the motivational climate then extant. The immediately preceding and still continuing pivotally catastrophic regulatory failure that was described in my April 7th letter [3] is all embedded in that, and it is intrinsically probable that it would have made going against the contemporary grain extremely hard, whether at the individual, function or organisational level.

3.4 Why then was it so hard, and what eventually would an earlier PO Report have had to address in the event that early closure had taken place? Though it would perforce have included the separate matters introduced by you and the Treasury and hence points 3-5 inclusively in my April 7th letter, it would I think inevitably have had to address another important issue, namely ELAS actuary Barry Sherlock and his Chairmanship of the Life Assurance and Unit Trusts Regulatory Organisation (LAUTRO).

3.5 It will be recalled that Mr Sherlock was Maurice Ogborn's successor and Roy Ranson's senior until he resigned as Actuary and General Manager of ELAS at the end of June 1991. He had been the ELAS Appointed Actuary until 1982 before handing over to Mr Ranson, and must be accorded the primary responsibility for having dispersed the Society's estate over that period. But he was also the Chairman of the Conduct of Business regulator LAUTRO from 1988 until it merged into the Personal Investments Authority (PIA) in 1994. Roy Ranson's dual role is one thing, but it would thus appear that for some considerable time Mr Sherlock was regulating himself!

3.6 Under these circumstances it is hardly likely that LAUTRO would have blown the whistle on either the Society's fraudulent transition in 1987-8, the false promise of the unbroken bonus series (see Appendix), or With Profits Without Mystery and its sequelae. Nor would it have taken kindly to any suggestion from the prudential regulator that enough was enough by 1990-1 (in which connection again please see the Appendix). Indeed LAUTRO is likely to have resisted any major initiative on the part of GAD and the prudential regulatory arm right up to the time of formation of the PIA.

3.7 At this point we may step out of our counterfactual and back into reality. Here the irony is that when the PIA eventually did start to run with the mis-selling issue Gordon Brown was himself Chancellor of the Exchequeur and the consequences of mis-selling to around a million new victims were by then so advanced and serious that the issue was kicked into touch by the prudential regulators to protect the Society's solvency [4, 10]. What the prudential regulator might properly have been minded to do earlier on it now blocked, and one person, namely Sir Howard Davies, headed both the prudential and Conduct of Business reporting lines, so having both the power and the means to trim the outcome.

3.8 At the same time there had been something of a sea change in the GAD. E.A Johnston and George Newton were in due course replaced by the likes of Christopher Daykin and William Hewitson. Meanwhile, as related in the PO2 chronology [6] and thus the Appendix, there was a residually ongoing clubbable actuarial undercurrent, which *inter alia* led to the GAD nominating Ranson [6] alongside Sherlock for the CBE. In sum, what under other circumstances GAD might have been minded to do earlier, it was perhaps less likely to do later on.

3.9 In rounding this section off, it is submitted that there were more than sufficient environmental factors in place at the time to say that the early closure counterfactual passes the necessary test of running against the contemporary motivational grain. In compensation terms it is likely to have sharply offset the overlarge inheritance of most existing members, but led to some rough justice for later GARs and non-GARs unless their special situation was recognised (following on from what you pointed out to me on April 15th, we have still to deal with that in any event). *Nor would the missing data problem have been quite so extensive and embarrassing as now it is.* Current arguments as to how to deal with market value adjusters (MVAs) and leavers versus those obliged to stay with the Society would seem valid in the counterfactual, although they would have been on a much smaller scale, and market considerations would at that time not have been the complicating and grossly misused factor they now are. The cost in terms of human havoc would also have been much smaller, although as you say that is more properly a hindsight observation.

3.10 It will be seen that the Appendix addresses these matters in a general way, which includes Peter Scawen's earlier observations to you on the effect of bonus declarations on policyholders' expectations and hence the viability of the Society. What is more, it accords with the PO's finding of maladministration with regard to the affordability and sustainability of bonuses that has been discussed above. And with regard to what you have written about the outcome of ongoing accountancy and actuarial disciplinary proceedings as they might affect members of GAD [IR3 para 6.8] it is noteworthy that they also address this time period. Official life being as it is, one should anticipate that the action at least partly springs from the PO's findings of maladministration. Conversely it follows that any final judgment is unlikely to have sufficient scope to be very helpful to us here, given our wider though highly relevant framework of consideration.

3.11 It is of interest that the Appendix also mentions resilience testing as being a central issue at this time, and so, *not entirely with hindsight, the strange fact that the net premium and gross premium valuation methods gave exactly the same or closely similar results should have been investigated much earlier.* Please again note what Sherlock is reported to have said about the Society's use of the unbroken bonus series and the manner in which it was represented. It is the one of the main keys to understanding the pivotally catastrophic failure of regulation over the period we have been considering. In this Mr Sherlock himself may reasonably be claimed to have had a close interest.

Summary and conclusion.

It has been explained why the regulatory expedients used in Towers Watson's counterfactual scenarios are of a type which can fairly be described as reverse regulatory arbitrage. That said, the significance of these devices and comforts has been overlooked in the PO's Procrustean Bed style of investigation. It should not therefore be assumed that other jurisdictions will allow that they fall within the acceptable limits of the regulatory system. If so, it follows that IR3 para 6.4 should be appraised and construed in that light. Now too there is the overall caveat that the effects of the Procrustean Bed method of investigation and causally inverted economical ruling are likely to be assessed together as well as individually by those jurisdictions. Therefore it is recommended that, if the reasoning behind IR3 para 6.4 is to be used any further, its scope and meaning should be more tightly defined.

Counterfactualisation is beset with pitfalls, which may explain why it is a sometimes contentious subject. Hence transparent reasoning should be used to make plain the methods used, as well as the criteria they are designed to satisfy. It has been proposed that in this case the important criterion in deciding what more properly should have taken place is that the hypothetical course of action should be a) intrinsically sound in its own right, and b) that it can be demonstrated to run counter to the prevailing contemporary individual or collective mindset on the assumption that the latter is suspect. The corollary of this line of reasoning is that alternative counterfactual scenarios which a) propose courses of action which are themselves potentially dangerous or unsound, and b) can otherwise reasonably be claimed to be part of a motivational mindset that is intrinsically suspect should be rejected. With appropriate reservations, that might give some comfort in the interpretation of IR3 para 6.4, but it now follows that a lenient interpretation of the permissible bounds of regulation would be suspect in itself.

Reasons are advanced as to why the early closure counterfactual scenario can be considered to meet the above criteria. Though it does not remove the need to address earlier overbonusing and to whom, or setting it against subsequent losses, the problems are in some ways the same but in others very much simpler than actually occurred later on. In the event they would also have been on a much smaller and more bearable scale.

In final conclusion, any comparator now used for compensation purposes which follows counterfactual lines, whether under Heads A, B or more likely both, should be modelled on a sound and prudently managed office which is radically different from the Equitable, and for obvious reasons a mutual one. Moreover with regard to IR3 para 6.4 the prevailing regulatory environmental counterfactual model should also be considerably tighter than was the actual case. As previously explained, the overall consideration is that there always should have been adequate free reserves to support both the with-profits and assurance elements of the business, the GAR and GIR included. That in turn allows a free assets based approach to both past and future loss, be it absolute or relative. Taking matters overall, it is submitted that this approach is suitable for UK, EU and international purposes.

I hope these further remarks may be of assistance, but should you require anything further please let me know.

Yours sincerely,

Dr Michael Nassim.

E-mail copies:

Dr Andrew Goudie; Peter Scawen (ELTA) ; Michael Josephs ; Margaret Felgate ; Nicholas Oglethorpe.

Acknowledgements.

Again I gladly acknowledge the help and support of those copied in. Their tenacious pursuit of the rightness of things over many years is a constant strength. On this occasion I have relied particularly upon Dr Goudie's advice and input. It can duly be seen in the finished product, and I am much indebted to him for it.

Abbreviations and Definitions:

CBE:	Commander of the British Empire.
CoB:	Conduct of Business.
DTBP:	Differential Terminal Bonus Policy.
ELAS:	Equitable Life Assurance Society.
ELTA:	Equitable Life Trapped Annuitants.
EQUI:	European Parliament: Committee of Inquiry into the crisis of the Equitable Life Assurance Society.
EU:	European Union.
GAD:	Government Actuary's Department.
GAR:	Guaranteed Annuity Rate.
GIR:	Guaranteed Interest Rate.
IR3:	Chadwick Third Interim Report.
LAUTRO:	Life Assurance and Unit Trusts Regulatory Organisation.
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.
UK:	United Kingdom.
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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Background Information.

MN's notes on his meeting with Sir John Chadwick, Laurence Emmett, Gareth Sutcliffe and Simon Bor at One, Essex Court on the afternoon of April 15th 2010. Final text as reconciled with Sir John's Office notes.

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APPENDIX.
EXTRACT FROM THE PARLIAMENTARY OMBUDSMAN'S CHRONOLOGY, COURTESY OF DR. ANDREW GOUDIE.

Chronology, Pages 41- 44:-

19/12/1990 [entry 2] GAD send DTI's Head of Life Insurance Division (Head of Life Insurance) two notes. The first is from Chief Actuary B, following the meeting with Equitable on 14/11/1990. The note begins by saying that:-

There is one point which we think you may need to consider following our meeting with Equitable. If, as seems possible, the society decides not to declare reversionary bonuses this year you would need to consider whether or not there is a risk that the society may be unable to fulfil the reasonable expectations of present and future policyholders.

It continues:-

In the event of the society not paying the reversionary bonuses this year, we understand that the intention is to pay interim reversionary bonuses at the 1989 rates in respect of 1990 on all policies maturing in 1991, thus making up for the effect of not declaring reversionary bonuses in 1990. The society intends to maintain payment of terminal bonuses at the appropriate level on policies maturing. This means that for policies maturing in 1991 there would be no adverse effect apart from any changes in the rates of terminal bonuses that might occur. We do not have any information at this stage about the society's likely intentions in respect of policies maturing later than 1991. In our view what happens at the end of 1991 and later will be largely determined by what happens to the stock market during 1991 and later.

The note then says:-

So far as policies maturing in 1991 are concerned, in our view the course of action which the society has suggested it may take does not affect their reasonable expectations – there is likely to be no big change in total bonus payments at maturity. The total bonus payments added to policies maturing in 1992 or later are likely to be more affected by stock market changes occurring in 1991 and later years than by whether or not the society pays a reversionary bonus at the end of 1990. The society may be able to declare a double reversionary bonus at the end of 1991 if the fund can afford it through good investment performance, or again, a special maturity bonus for 1990 may be awarded for claims in 1992, and so on. In effect, total maturity proceeds would be maintained though (on the latter scenario) less would come from reversionary bonuses, with the company having missed awarding one such bonus in 1990.

Chief Actuary B concludes:-

Hence, on balance, we do not think that the society's possible course of action, in itself, leads to a risk that the society may be unable to fulfil the reasonable expectations of such policyholders. If the society had another bad year (or this year's performance is worse than anticipated) and the company was unable to establish sufficient mathematical reserves on current guaranteed levels of benefits (including past reversionary bonuses) within the resources of the company, that would be a different matter.

At present we do not have enough information about the society to be more specific and indeed, unless the society makes more signals, we do not suggest that further information should be sought. The society is our longest established life company and is well respected in the market.

The second note is from Directing Actuary A.

He begins by stating:-

After the meeting held yesterday with the actuarial profession, in which there was general agreement that the resilience test under regulation 55 would continue to be calculated on the basis of a 25% fall in the value of equities in current market conditions and present economic and political circumstances, we discussed the position of Equitable, given that decision. You mentioned that you were concerned about their current advertising. This was in the context that, if the Equitable were unable to pay a reversionary bonus this year, policyholders who had taken out policies on the basis of recent advertisements (which highlighted the returns achieved by the Equitable over the past 10 years), might have justification for wondering whether their reasonable expectations would be, or were being, met. You would like the Equitable to examine their advertising to ensure no such complaint could be justified.

It was agreed, therefore, that the most appropriate way of getting this point over to the Equitable would be for me to telephone [the Chief Executive], *informing him both about the decision taken at the meeting yesterday and also to put the point to him about the company's current advertising.*

The note continues:-

When I telephoned [Equitable's Chief Executive] *earlier this morning, his secretary told me that he was in a Board meeting which would last most of the day. I wondered then if in fact the Board meeting was deciding on what reversionary bonuses should be paid this year.* [The Chief Executive] *eventually telephoned me back late in the afternoon, and I explained that I was telephoning him, rather than* [the Appointed Actuary] *because, although the first point was one on which I would normally speak to* [the Appointed Actuary]*, the second was one on which it would be more appropriate to speak to him. I explained that, on the first issue, I wanted as a matter of courtesy to tell him the result of yesterday's discussions, which confirmed the conversation I had with him a week ago at the Actuaries Club Dinner when I told him what I thought would be the outcome of our discussions with the profession. He said that he was very grateful for letting him know.*

The note continues:-

*I then went on to say that, on the second point, some officials in DTI had expressed some concern that, if the Equitable were to forego a reversionary bonus this year, some policyholders might wish to complain that they had been misled by the Equitable's recent advertising**. I said that I was sure that he,*** **[the Chief Executive],** ***would be very mindful of the question of advertising and marketing, with his intimate connections with LAUTRO (emboldening AJG/MN).*** *I told him that what I was trying to indicate in general terms was that if the company was of the view that it was unlikely to declare a reversionary bonus at the year end, it would be helpful if the company were to examine its advertising and marketing literature to ensure that it felt it was not misleading prospective policyholders in the run-up to the announcement*.*

[The Chief Executive] *took these comments in the kindest possible way. He said that he was clearly anxious that the company did not mislead any potential policyholders, that it had been their intention to concentrate on the actual payouts over the last 10 years and it was the company's continued intention to ensure that policyholders maturity proceeds continued to reflect the full performance of the company over the period of the policy, even if a year's reversionary bonus were foregone. However, as a result of the Board meeting which he had just left, he thought he could put my worries at rest by telling me what the outcome of the meeting was.*

The note goes on to say:-

It appears that [Equitable's Appointed Actuary] *had presented a paper to the Board which sets out the constraints on bonus policy which emanate from the valuation of liabilities regulations themselves. The company accepts that the regulations are a matter of fact, and have to be abided by. (He also told me that he had passed on to the Board my comments at last week's dinner that it would be very difficult for the UK to weaken its valuation regulations at the present time when we are having to defend them to other Member States in the context of the Single Market after 1992.)*

He then went on to tell me that the view of the Board was that the crunch position for the company would really probably come next year. The Board had received a report from their investment committee which examined the most likely, and the worst likely, outturn for 1991. As far as the most likely outturn was concerned, the view of the Committee was that the investment performance of the company would be quite strong. While there were some pessimistic underlying economic indicators for next year, the report concluded, and the Board accepted, that the most likely outturn for the year was likely to be optimistic. What the company wishes to avoid is to declare a reversionary bonus this year, and then to be unable to declare a reversionary bonus next year when there is an investment upturn. In his view, although the board has not taken any final decisions yet, he considers that it is "pretty unlikely to be in a position of not being able to declare a bonus this year" given the optimistic assessment of investment returns achievable by the company next year.

[Equitable's Chief Executive] *told me that there was clearly a risk in this strategy, but there is a risk in all bonus declarations taken in similar circumstances. I did not enquire of* [the Chief Executive] *what the likely financial position of the company* *would be at the end of this year in terms of Form 9 solvency margin – I know that* [the Chief Executive] *had to go to another urgent meeting at that time and also I do not consider the telephone to be the best medium for discussing such matters.*

The note concludes:-

In summary, therefore, it seems most likely that the Equitable will declare a reversionary bonus this year, having taken an optimistic view of investment return likely to be achieved by the company in 1991. On that scenario, they would anticipate that they will be able to continue to pay a reversionary bonus next year.

There is clearly some risk in this strategy, and if the Equitable goes ahead with a bonus distribution this year and the market subsequently falls considerably, we will need to hold some urgent talks with the company's actuary, as we would, of course, with other companies that take similar decisions and who are in a similar financial position to (or an even less strong position than) the Equitable.

*My current understanding is that Ken Wills and Shaun Kinnis, directors who were successively responsible for advertising and marketing over the contentious period under consideration, were both qualified actuaries. If so, they are likely to have been fully conversant with the WPWM business model and the circumstances which necessitated it. They would also have been in a position to understand and respond appropriately to the general thrust of its actuarial discussion. The particular inference here, however, is that Mr Sherlock should also have been monitoring his sales and marketing director appropriately at this time. MN.