EQUITABLE LIFE

UPDATE

OCTOBER 2008

INTRODUCTION

The Commission has regularly published updates to inform interested policyholders of the Guernsey branch of Equitable Life of matters which it considers significant.

In July this year a significant development occurred in the form of publication of a comprehensive report for the Parliamentary Ombudsman ('PO'). This report made a number of findings of maladministration on the part of the prudential regulators of Equitable Life and it recommended that the UK Government establish a compensation scheme to provide redress to policyholders.

We hope that interested parties will find this update briefing useful. The Commission has sought to summarise both relevant historical information and the present stated position of those with vested interests in the UK Government response to the recommendations of the Parliamentary Ombudsman.

INDEX

1. BACKGROUND TO CURRENT POSITION

As Equitable policyholders will know, in July 2000 Equitable Life lost a high profile and well publicised case in the House of Lords. The decision declared Equitable's policy of cutting bonuses for GAR policyholders unlawful, which left Equitable with a £1.5 billion liability. In the following December, after failing to find a buyer for the Society, Equitable was forced to close its doors to new business.

Starting with the Corley report in 2001. A number of formal enquiries have been established, to examine the circumstances surrounding the failings at Equitable Life and why Equitable was so exposed to a GAR liability that was, to a greater or lesser extent, common to all the life and pensions market. Short summaries of each of the key reports are included in this note but perhaps the most important reports are the European Parliament ('EP') report in 2007 and, most recently, the long awaited second report of the Parliamentary Ombudsman in July 2008.

These two reports make similar criticisms of both the management of Equitable Life and the public bodies responsible for its prudential regulation in the UK. The Parliamentary Ombudsman's report reiterates the suggestion made in the European Parliament report for the provision of formal redress for policyholders paid for by the UK Government. The key recommendation in both reports is for the UK government to establish a compensation scheme for policyholders who are able to establish that they suffered a loss.

For an overview of the key events see Appendix

2. WHY WAS EQUITABLE SO EXPOSED TO THE GAR PROBLEM?

Both the Corley and the Baird reports (see the following Section 3) contain a number of observations which help to explain why Equitable appeared to be so uniquely vulnerable to a problem (of the cost of contracts containing GARs) which affected the whole life and pensions market.

In summary, between 1957 and June 1988 Equitable, along with many other mutual life insurance companies, included as a standard feature in certain types of pension policies the promise of an annuity paid at guaranteed rates, or a GAR. In 1993 current annuity rates slumped and from mid-1995 onwards the value of GARs were consistently higher than the current market annuity rates. 'By September 1998, GAR's in policies issued between 1957 and 1988, were approximately 30% higher than current annuity rates.'

Equitable was far from being the only life assurance company exposed to the market conditions in relation to GAR policies, but it was in an almost uniquely exposed position compared to its competitors for two reasons. Firstly, Equitable had written 116,000 GAR policies, a far higher proportion of its business than any of its competitors and, secondly, 'because [of] Equitable Life's long-standing philosophy ... to provide a full distribution of profits to its policyholders,' it did not have any potentially available capital reserve to absorb the liabilities and 'satisfy solvency requirements ... [in addition,] as a mutual, it had no shareholder funds on which to draw.'

Equitable introduced a policy of cutting terminal bonuses for those policyholders opting to take the GAR. However, the House of Lords ruled in 2000 that this policy effectively negated the value of the GAR, which was a contractual entitlement in the hands of the policyholders, and the bonus policy was declared unlawful. Equitable was left with a £1.5 billion liability to meet, which could only be met by a means which would affect all with-profit policyholders as Equitable had no other surplus available to meet this unexpected exposure.

3. OVERVIEW OF THE FORMAL REPORTS

September 2001: Report of the Corley Committee of Inquiry regarding the Equitable Life Assurance Society

An independent Committee of Inquiry established by the Actuarial Profession in December 2000 reviewed the 'events surrounding the closure of the Equitable Life Assurance Society ('ELAS') to new business and its implications for the profession.' The Committee focused on whether the events at Equitable highlighted any lessons to be learnt by actuaries and 'particularly whether the Guidance Notes which the ... Institute provide to the profession needed any amending, strengthening, extending or rewriting.'

The report was limited to a review of the period up to July 2000 and limited in scope to a 'review, with the benefit of hindsight, [of] the adequacy of professional guidance and the implication[s] to the role of actuaries.' The Committee was not required to reach conclusions about the conduct of Equitable, its board, or the regulators. However, the report does provide a useful overview of the events at Equitable since 1956 and some general comments on why Equitable was more susceptible to market circumstances during that time.

The Corley report made a number of recommendations with regard to actuaries conduct and suggested amendments to guidance notes to clarify the rules governing actuaries.

October 2001: Baird report: 'The Regulation of Equitable life: an independent report'

The inquiry was requested by the FSA in December 2000 and was led by the FSA's Director, Quality & Internal Audit, Ronnie Baird. The scope of the report was limited to the discharge of functions by the FSA and the Personal Investment Authority ('PIA') in the very short period from January 1999 to December 2000.

The report concludes that the FSA had failed to spot key problems, or if it had spotted issues, it failed to follow them up. The report also highlights the lack of foresight by the regulators in failing to take into account the repercussions of the House of Lords decision on guaranteed annuities in July 2000. However, the report essentially concludes that the 'die was cast' before the FSA became responsible for regulatory control and that their conduct, despite its shortcomings, could not have materially affected the outcome at Equitable Life.

June 2003: Parliamentary Ombudsman initial report

The report was limited to the period of time covered by the Baird report i.e. January 1999 to December 2000. The report was also limited in scope including an inability to review the role of the Government Actuaries Department ('GAD').

The initial report concluded that there was 'no evidence to suggest that the FSA...had failed in its regulatory responsibilities in respect of Equitable Life during the period in question.'

March 2004: Penrose report: 'Report of the Equitable Life Inquiry'

In August 2001 the government decided to launch an independent inquiry into the events at Equitable Life headed by Lord Penrose. The remit of the inquiry was to 'enquire into the circumstances leading ... [up to] the ... situation [at] Equitable Life Assurance Society, taking account of relevant life market background; to identify any lessons to be learned for the conduct, administration and regulation of life assurance business....' The Penrose report had no power to make recommendations to government regarding the situation with the Equitable Life.

The report criticised the management of the Equitable and commented that the 'Society was principally responsible for its own misfortunes.' However, the system of regulation was also criticised and the GAD was singled out for being insufficiently tough in its regulation of the Society.

June 2007: European Parliament Report on the Crisis of the Equitable Life Assurance Society (2006/2199(INI))

In January 2006 the EP established the Equitable Life Inquiry Committee following the receipt of two petitions from Equitable Life policyholders. The Committee was set up to consider 'whether European rules were breached, asking whether the UK properly transposed and respected EU directives, whether the Commission was at fault in inadequately checking UK rules, or whether the UK authorities themselves were at fault [for the failures at Equitable Life].'

The final report was published in June 2007 – see next Section 4.

July 2008: Parliamentary Ombudsman report 'Equitable Life: a decade of regulatory failure'

In July 2004, following pressure from action groups and the publication of the Penrose report, the PO agreed to re-open her investigation and provide a fuller investigation into the events at Equitable Life, including a review of the role of the GAD.

The report took four years to produce and was finally published in July 2008 – see next Section 4.

4. SUMMARY OF KEY REPORTS ON EQUITABLE LIFE

A. The EP Committee report

(i) What was the scope of the report?

The Committee of Inquiry was only able to investigate 'alleged contraventions or maladministration in the implementation of Community law in relation to the collapse of the Equitable Life Assurance Society.'

The scope of the investigation was limited by the mandate, which asked the Committee to focus on four key issues:

'1- investigate alleged contraventions or maladministration in the application of Directive 92/96/EEC, now codified by Directive 2002/83/EC, by the United Kingdom's competent authorities in relation to Equitable Life, notably as regards the regulatory regime and the monitoring of the financial health of insurance undertakings, including their state of solvency, the establishment of adequate technical provisions and the covering of those provisions by matching assets;

2- assess whether the Commission has properly fulfilled its duty to monitor the correct and timely transposition of Community law and identify whether systematic weaknesses contributed to the situation that has arisen;

3- assess allegations that the UK regulators consistently failed, over a number of years, and at least since 1989, to protect policy holders by exercising rigorous supervision of accounting and provisioning practices and the financial situation of Equitable Life;

4- assess the status of claims by non-UK European citizens and the adequacy of remedies available under UK and/or EU legislation for policy-holders from other Member States'

(ii) What did the report conclude?

The report concluded that EU directives were inadequately implemented in the UK. It commented that the UK regulatory system had demonstrated '**excessive leniency on [Equitable's] solvency margin.**' This regulatory failing was attributed in part to the UK's "**light-touch regulatory policy**", which the report states '**contributed to a weak regulatory environment, which allowed the difficulties at ELAS to grow unchecked, when in a stronger regulatory system they might have become apparent at an earlier stage and the final crisis might have been prevented.**'

The report criticises the regulator for its deference towards senior management at Equitable and for failing to challenge the conflicts of interest that arose when Roy Ranson acted as both Equitable's Appointed Actuary and simultaneously as its Chief Executive.

The Committee suggests that statements show that 'many of the victims of the ELAS crisis had great difficulty knowing what route to take or who to apply to in trying to obtain information, make a complaint and obtain redress.' It comments that the form of redress was limited, with the UK's Financial Ombudsman's Service ('FOS') not constituting an 'appropriate means of redress for the grievances of a vast majority of Equitable Life policyholders...' and an alternative being expensive court proceedings, an option, in reality, only available to particularly affluent policyholders.

The report is critical of the lack of availability of redress for certain policyholders, particularly German and Irish policyholders. No such issue arose for policyholders of the Guernsey branch. Following exchanges between GFSC and the FOS, and the office of the PO, it was agreed that from the perspective of eligibility for redress, Guernsey branch policyholders were in no different a position to UK policyholders.

The Report's concern over the availability of redress for non-UK policyholders was identified as follows:

'...[N]o non-judicial routes for redress seem to have been available to Irish and German policyholders in their respective home countries, apart from those complaints submitted to the Insurance Ombudsman of Ireland scheme, which seem to have been investigated'.

'...[S]tatements made to the committee make it clear that Irish and German policyholders were not able to obtain redress for their grievances through their respective national financial regulators.'

'Overall, it appears that non-UK policyholders did not have access to appropriate non-judicial redress schemes in the UK. Therefore, they find themselves in an even more unfavourable position than UK policyholders. This lack of clarity about whom, if anyone, policyholders could address even led one non-UK national to submit a complaint to the European Ombudsman, who had no standing in the matter.'

(iii) What did the report recommend?

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

It also 'urges the UK Government and all affected parties to accept and implement appropriately any recommendations the UK Parliamentary Ombudsman may take [in her second report.]'

The EP has no power to force the UK government to adopt its recommendations and establish a compensation scheme.

(iv) What has been the government's response to the report?

The government has yet to respond to the EU report. After the EU report was released a Treasury spokesman commented that "[it] would not be appropriate for the Government to comment on the substantive findings made in the [European Parliament] report, pending the outcome of the UK Parliamentary Ombudsman's investigation into the regulation of Equitable Life."

B. The Parliamentary Ombudsman report: 'Equitable Life: a decade of regulatory failure'

(i) What was the scope of the report?

The PO's terms of reference for this investigation were '[t]o determine whether individuals were caused an injustice through maladministration in the period prior to December 2001 on the part of the public bodies responsible for the prudential regulation of the Equitable Life Assurance Society and/or the Government Actuary's Department; and to recommend appropriate redress for any injustice so caused.'

Therefore the scope of the PO's investigation was limited to action taken during the period prior to December 2001 by the DTI and the Treasury as prudential regulators of the Society and to the action taken by the FSA and GAD on behalf of those regulators.

The Ombudsman's approach was to establish an overall standard that applied during the period under review. Then by reviewing the facts she assessed 'whether an act or omission on the part of the body complained about constituted a departure from the applicable standard.' If there was a departure from that standard the next question was 'whether that act or omission was so unreasonable, or fell so far short of acceptable standards of good administration, as to constitute maladministration.'

(ii) What were the findings of the PO?

The Ombudsman made ten determinations of maladministration; one against the Department of Trade and Industry ('DTI'), four against the GAD and five against the FSA.

1. The DTI failed 'to insist, when approving the appointment in June 1991 [of Roy Ranson as the new Chief Executive] that he should demit ... [the role of] the Society's Appointed Actuary.' For the next six years, whilst he held dual office, they failed to consider their power to remove him from the role.

2. The GAD failed 'to question and seek to resolve questions within the Society's annual regulatory returns [from 1990-1993]. These questions 'related to (i) the valuation rate of interest used to discount [their] liabilities and (ii) to the affordability and sustainability of the [bonuses the Society was declaring].'

3. The GAD was aware Equitable had introduced a differential terminal bonus policy, by restricting the value of benefit paid to the total policy fund, but it failed to inform prudential regulators about the policy and failed to raise the matter with the society. The legality of this policy was later challenged in a test case taken to the House of Lords. The law lords found unanimously against Equitable in 2000.

4. For the annual regulatory returns from 1994 to 1996 the GAD 'in providing advice to the prudential regulators, failed to satisfy themselves that the way in which the Society had determined its liabilities and had sought to demonstrate that it had sufficient assets to cover those liabilities accorded with the requirements of the applicable Regulations.' The regulators were thus 'unable to verify the solvency position of the Society.'

5. GAD failed to raise or resolve the issue of information omitted from Equitable's regulatory returns, which led the reader to incorrectly assume that Equitable was more financially sound than it was, even when GAD had information that industry rating agencies were misconstruing the company's financial strength.

6. The FSA, acting on behalf of regulators, failed 'to ensure that the financial reinsurance arrangement was not taken into account within the Society's 1998 return without proper concessions being given.' The FSA allowed Equitable 'within its returns for 1998, 1999, and 2000 to take credit for the reinsurance arrangement that did not reflect the economic substance of that arrangement.' Policyholders 'were given a wholly misleading picture of the true position due to the unreasonable credit taken for the reinsurance arrangement.' In addition the FSA permitted the Equitable to declare a bonus in March 1999. 'Had the society not done so, a warning would have been given to those considering investing in the society for the first time, or to those considering making further contributions to existing policies that the society was in significant financial difficulty.'

7. The FSA failed to pursue Equitable over its failure to disclose the potentially serious financial impact of losing the *Hyman* litigation, a court case testing the legality of the differential terminal bonus policy. 'Existing and potential policyholders were thus denied information about their potential exposure to a significant risk, which was an integral part of informed decision-making as to their financial options.'

8/9 There are two findings relating to the "unsound basis" on which the decision was taken by the FSA to allow Equitable to remain open to new business after it had lost the House of Lords case and a failure by the chief City watchdog to record this decision.

10. Reassurance provided by the FSA in the period after Equitable closed to new business in December 2000 was based on 'incomplete and inaccurate information...' this resulted in 'misleading information about the position of the Society being provided to existing policyholders...'

The first and second findings in particular are criticisms also made in the EU report. The findings in relation to GAD are not within the scope of the EU Committee's investigation.

(iii) What did the PO recommend?

The Ombudsman has made two key recommendations.

Firstly, that the relevant public bodies apologise to policyholders for the 'justifiable public outrage' that has been caused by their failures.

Secondly, that the government should 'establish and fund a compensation scheme.'

(iv) What is the relevance of the PO report?

Whilst the PO is independent of the government and has the power to investigate government departments and make recommendations, the government is not legally obliged to accept the PO's findings or implement any recommendations.

The PO has invited Parliament to consider the issues that have been raised in the report, the recommendations made and to reflect on what its response should be. The current position is that the government has said it will review the report and respond this autumn after it has returned from summer recess.

5. THE POTENTIAL FOR COMPENSATION TO BE PAID AS RECOMMENDED BY THE PARLIAMENTARY OMBUDSMAN

A. Who may be entitled to compensation?

Subject to an assessment of individual circumstances, all with profits policyholders are potentially entitled to compensation. In Part Five of the report the PO concludes that with regard to compensation 'the individual circumstances of each complainant ... are key to establishing whether those people are in the category of those who have suffered relative loss.'

There are potentially a number of groups with different claims. The with-profit annuitants that were transferred to Prudential in February 2007 may have an argument that the value of their transfer should have been higher. Those that joined the Society after 1999 may claim they would not have joined if they had been aware of the Society's true financial position and policyholders with guarantees may have a claim where those guarantees were not met. In addition, family members of deceased Equitable policyholders may argue that the deceased's estate should be entitled to receive compensation.

Part Five of the report makes clear that the PO recommends '[t]he scope of ... a [compensation] scheme ... should include not just residents of the United Kingdom but all those who have sustained the injustice that ... resulted from maladministration.' It is the PO's recommendation that international policyholders and therefore the policyholders of the Guernsey branch should be eligible under any compensation scheme.

B. How much compensation is being recommended?

The report only recommends that a compensation scheme should be established and that 'the aim of such a scheme should be to put those people who have suffered a relative loss back into the position that they would have been in had maladministration not occurred.' There have been many expert opinions from leading counsel which have addressed this issue, but so far as we are aware there has not been a consensus of opinion on the single correct approach to the basis for compensation.

The PO report does not suggest a figure for compensation. However, EMAG suggests that assuming about 70 per cent of policyholders can show that they have suffered loss the figure for compensation could amount to £4.5 billion.

C. If the government agrees to pay compensation, how will it operate and how long will it take?

The Ombudsman recommends that any scheme should be independent and should consist of an adjudication panel or tribunal, with three members; one of whom to broadly represent the interests of those affected, one to represent the regulatory body, and an independent chair. The PO also recommends transparency and simplicity in the scheme which should not impose 'undue burdens, whether evidential or procedural, on those making claims to the scheme.' Other than making these high level observations it has avoided commenting on how the panel might work.

The PO recommendation is that a scheme should be set up within six months of a decision by Parliament to provide compensation, with the compensation to be paid to policyholders within two years after that.

6. WHAT NEXT FOR EQUITABLE POLICYHOLDERS?

At present there is little significant new commentary by the press because all interested parties are awaiting a response from the government to both the European Parliament and the Parliamentary Ombudsman's reports.

The government has received criticism from MEPs, the press and policyholder action groups for their delayed response. In a preliminary response in July the government stated that it would be unwilling to meet Ms Abraham's demands and that it was beyond her remit to call for compensation to be paid. However, the government has said it will publish a full response to the report when Parliament returns from summer recess.

Whilst policyholders wait for the government's response, EMAG and MEPs are encouraging policyholders to lobby MPs for the government to respond to the reports. EMAG has also created an online petition calling for the UK government to set up a compensation scheme and respond to the EU report.

The Commission welcomes the European Parliament and Parliamentary Ombudsman reports and is in support of a prompt response from the government to both. The Commission will continue to monitor developments and keep policyholders updated.

APPENDIX: CHRONOLOGY OF EVENTS

1762
- Equitable Life ('EL') is founded.

1913
- EL starts to sell pensions.

1950's
- EL begins selling GAR policies.

1980's/1990's
- Equitable stops selling GAR policies. (1988)
- Due to fall in interest rates/inflation, current annuity rates drop and GARs become expensive to honour.

1991
- Roy Ranson becomes Chief Executive of EL whilst retaining role as Appointed Actuary.

1994
- EL announces its plans to cut bonuses to 90,000 GAR policyholders.

1997
- Ranson retires as Managing Director and Appointed Actuary.

1999
- EL launches court proceedings to gain approval for its bonus cuts.

2000
July
- The House of Lords rules that EL must meet its obligations to GAR policyholders and its policy of cutting bonuses was unlawful.
- EL left with £1.5 billion liability and is forced to puts itself up for sale.

December
- After failing to find a buyer EL closes its doors to new business.
- EL increases penalty fee for withdrawing funds.
- EL begins to sell-off operations to generate cash to pay policyholders

2001
February
- Halifax agrees to buy EL's sales force and non-profit policies for £1billion.
- Slater resigns as president and Vanni Treves is appointed as Chairman.

March
- Headdon resigns as Chief Executive and Charles Thomson is appointed.

July
- EL announces reduction in value of with-profits pension policies by about 16%.

August
- Government announces independent inquiry into situation at Equitable Life under Lord Penrose.

September

- EL publish a compromise deal for policyholders:
  - EL offers 70,000 GAR policyholders a 17.5% increase in the value of their plans, but they must sign away their guaranteed pension rights.
  - EL offers 415,000 other policyholders a 2.5% increase, but they must sign away their rights to any legal claims.
- The Corley Report into EL is published.

October

- The Baird report is published.
- Ruth Kelly MP, economic secretary to the Treasury, says the government might consider compensation for some victims if a 'grave injustice' has occurred.

2002

January

- Policyholders vote in favour of the compromise package.

April

- EL issues a £2.6 billion damages claim for professional negligence against Ernst & Young (its former auditors).
- EL announces plans to sue 15 former directors for £3 billion.

November

- Income paid to 50,000 with-profit annuity policyholders is cut by 20%.

2003

June

- Parliamentary Ombudsman, Ann Abraham, issues her initial report on Equitable Life. The report clears the FSA of any wrongdoing with regard to its regulatory responsibilities.

July

- The Court of Appeal rules that Equitable Life is allowed to sue its former auditor, accountants Ernst & Young. The claim is restricted to damages for the "loss of the chance of sales" rather than actual sales.

2004

March

- Penrose Report is published. The report accuses the former EL management of "dubious practices" and nurturing a "culture of manipulation and concealment". The report is also critical of the regulatory regime of the GAD.
- The government rules out the possibility of compensation and consequently is accused by MPs of abandonment.

July

- 700 pensioners ("trapped annuitants") lodge a multi-million pound claim against EL.
- Parliamentary Ombudsman announces she will reopen her investigation into EL.

2005

April

- The trial against EL former auditors, Ernst & Young, and 15 former directors commences.

September

- EL drops case against Ernst & Young.
- EL drops case against former directors at a cost of £10m.

2006

January

- European Parliament announces investigation into EL.

2007

February

- EL transfers £4.6 billion of non-profit pension annuities to Canada Life following approval from the High Court.

June

- European Parliament Report on the Crisis of the Equitable Life Assurance Society is published. The report calls on the UK government to compensate EL policyholders. MEPs recognise that they have no power to enforce their recommendations.

November

- The High Court approves deal to transfer £1.8 billion with-profits annuity policies to Prudential.

2008

January

- EL agrees to pay undisclosed sum to 407 with-profits annuitants who launched proceedings against EL in the High Court in 2004.

July

- The Parliamentary Ombudsman publishes her second report 'Equitable Life: a decade of regulatory failure'.