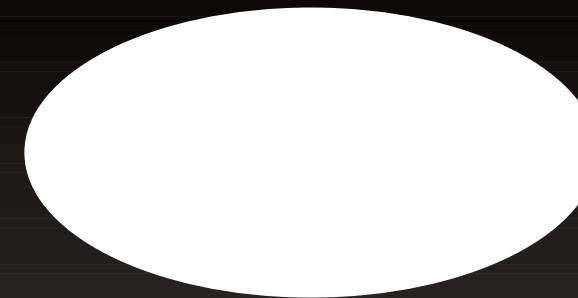


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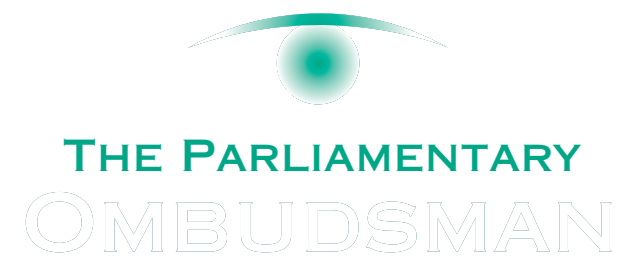
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Part I: Overview and Summary of Findings



HC 809-1



The Prudential Regulation of Equitable Life

Part I: Overview and Summary of Findings

4th REPORT – SESSION 2002-2003

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Overview: The prudential regulation of Equitable Life

Introduction

1. On 8 December 2000 the Equitable Life Assurance Society (Equitable) closed to new business after having been unable to find a buyer for the company. Over subsequent months my predecessor received a large number of complaints about Equitable. Initially, many of the complaints related to the actions of the company itself, involving allegations of mismanagement of the Society's affairs or mis-selling of individual policies; both matters outside the Parliamentary Ombudsman's jurisdiction. A minority referred to alleged failures in the regulatory system, contending that the prudential regulators should have taken action at an early stage to protect the interests of Equitable's policyholders. The number of complaints increased significantly from June 2001 onwards, after Equitable had announced significant reductions in policy and annuity values.

2. My predecessor initially took the view that it would be inappropriate for him to intervene in the matter on four grounds:

- i) First, the Parliamentary Ombudsman has an extremely limited scope for action in relation to complaints about Equitable. The actions of the Society itself, its auditors and actuarial advisers, and those charged with regulating the conduct of Equitable's business are not within jurisdiction. To begin an investigation into only one aspect of the situation, namely the actions of the prudential regulator, might raise policyholders' expectations unreasonably and might pre-empt a more comprehensive response.
- ii) Secondly, at that stage no *prima facie* evidence of maladministration on the part of the regulators had been provided to my Office. Whilst it was clear that policyholders felt a sense of outrage at what had transpired at Equitable and, in particular, in relation to the reduction in the value of their annuities, no specific examples of the prudential regulator acting improperly were cited, simply the broad allegation that there must have been 'serial regulatory failure' for those events to have happened.
- iii) Thirdly, it is the normal practice of my Office to give bodies within the Parliamentary Ombudsman's jurisdiction which are the subject of complaints an

opportunity to put matters right before deciding whether or not to intervene. The Financial Services Authority (FSA) had been contracted by Her Majesty's Treasury to carry out the functions of the prudential regulator from 1 January 1999 until FSA assumed full responsibility for those functions on 1 December 2001. In December 2000 FSA had announced that they would establish an internal review to consider whether they had properly discharged their regulatory functions (both prudential and conduct of business regulation) in respect of Equitable.

- iv) Finally, it was unclear initially what action the Government would take in response to the situation at Equitable and whether they would establish an independent and comprehensive inquiry. Subsequently, on 31 August 2001, the Economic Secretary to the Treasury announced that the Government had asked Lord Penrose to conduct an independent inquiry into the situation at Equitable. The inquiry's terms of reference were:

"to enquire into the circumstances leading to the current situation of the Equitable Life Assurance Society, taking account of relevant life market background; to identify any lessons to be learnt for the conduct, administration and regulation of life assurance business; and to give a report thereon to Treasury Ministers."

3. However, my predecessor continued to receive complaints from Equitable policyholders and their Members of Parliament contending that the Penrose Inquiry raised problematical issues. First, because it was to report to Treasury Ministers, and the Treasury had been responsible for the regulation of Equitable for at least some of the period in question. Secondly, it was unclear whether or not the final report would be made public in full, due to questions of professional and legal privilege and the restrictions on disclosure of information contained in domestic and European legislation. Finally, the remit of the Penrose Inquiry would preclude it from making judgments about maladministration and it was uncertain whether it would address a key question for policyholders: that of redress.

4. On 16 October 2001 the internal FSA review of their regulation of Equitable during the period from 1 January 1999 to 8 December 2000 (when the Society had closed to new business) was published. This review, known as the Baird Report, found that - with hindsight - there had been some "deficiencies" on the part of FSA in the discharge of their regulatory responsibilities, but also stated that "the die had been cast" by the time that FSA had assumed regulatory responsibility for the Society in relation to those who had already invested in Equitable.

5. In light of the findings of the Baird Report, and the uncertainties relating to the Penrose Inquiry, my predecessor announced in October 2001 that he would conduct an investigation into the prudential regulation of Equitable. The investigation would be limited to the period covered by the Baird Report (which had provided the *prima facie* evidence of alleged shortcomings on the part of FSA), would be of a single representative complaint (the Parliamentary Commissioner Act 1967 (the 1967 Act) does not provide for class actions) and would involve a complainant who had invested in Equitable during that period.

6. On my appointment as Parliamentary Ombudsman on 4 November 2002, I undertook as a matter of priority a review of my Office's investigation. I reported the results of that review to all Members of Parliament in a letter dated 5 December 2002. I explained that, in light of the fact that it had become clear that the Penrose Inquiry, which was looking at all aspects of these events, was prepared to make adverse findings about any of the relevant parties should the evidence justify this, I saw no basis at that time to depart from the decision taken by my predecessor to limit the scope of my Office's investigation to the time period covered by the Baird Report.

7. My Office's investigation is now complete. I consider the outcome of that investigation to be of general interest and I have therefore decided to lay my report before each House of Parliament under section 10(4) of the 1967 Act.

8. The report is in two Parts. Part II contains the detailed investigation report into the representative complaint and sets out the actions of the prudential regulator in relation to Equitable throughout the period under investigation. The report has been anonymised in accordance with my Office's normal practice. This Part (Part I) provides a summary of the key findings (see Appendix), sets those in a wider context and draws to Parliament's attention matters which I consider to be of significance.

Findings and wider context

9. I did not find evidence to suggest that FSA acting as prudential regulator had failed in their regulatory responsibilities during the period under investigation. Nor did I find that the decisions which the prudential regulator had taken as to what action (either formal or informal) was required of them in relation to Equitable were outside the bounds of reasonableness, given the information they held and the legal and actuarial advice which they

received. However, what I could not comment on, because of the very strict limitations on my jurisdiction (which are set out in detail in paragraphs 3 to 6 of Part II of this Volume), was the advice and information provided to the prudential regulator which informed those decisions, or the actions or inactions of any of the other key parties to these events, all of whom were outside my jurisdiction. Because of those limitations, which are the result of express provisions of the statute governing my remit, I could look at only a very small part of what is a much larger and more complex picture. My predecessor had expressed strong reservations as to whether such a restricted investigation could properly establish the key determinants in these events, and the lessons to be learned from them. He suggested that an inquiry, which could consider the actions of **all** the relevant parties to events over the whole time period in question, would have been more appropriate and more likely to deliver the comprehensive account of what happened in this case that policyholders and others were seeking. From my experience of looking into the actions of just one of the relevant parties to these events over a relatively short period of time, I am firmly convinced that he was correct in that view.

The prudential regulatory regime

10. There is, however, one central aspect of the Equitable case which my investigation has served to highlight and which I believe to be key to many of the complaints which my Office has received, and to the general outrage expressed about the role of the prudential regulator in this matter, and which I should therefore draw to the attention of Parliament. That is the fundamental mismatch between the nature and expectations of the prudential regulatory regime under which FSA were required to operate during the period in question, and the understanding and expectations that policyholders and others appear to have had of that regulatory system.

11. The principal actuarial and accounting provisions of the regulatory framework, including the key statutory requirements, are described in paragraphs 8 to 37 of Part II of my report. These clearly demonstrate that the requirements placed on the prudential regulator were firmly grounded in a 'light touch' approach to regulation. The philosophy underpinning the regime was that market forces would provide the best means of ensuring that an industry met the needs of its customers. The detailed regulatory provisions were framed to reflect that approach and to avoid over-interference in a company's affairs. It was never envisaged that that regime would provide complete protection for all policyholders. Indeed it was expressly stated in the service level agreement between the Treasury and FSA that:

"The Treasury and FSA agree that it is neither realistic nor necessarily desirable in a climate which seeks to encourage competition, innovation and consumer choice, to seek to achieve 100% success in avoiding company failure. FSA will therefore pursue its supervisory objectives by aiming to minimise,

existing policyholders. New policyholders could also be compensated, under the conduct of business rules, if they sustained losses as a result of joining on the basis of misleading information.

20. During the sales process Equitable launched an advertising campaign which was controversial. I found that the prudential regulator decided that, as Equitable were still meeting all the prudential regulatory requirements (and any intervention could have made the position for policyholders worse by reducing the prospects for a successful sale), they had insufficient grounds for formal intervention. They decided instead to bring informal pressure to bear on Equitable, which they did. That was a discretionary decision on their part which, given the circumstances at the time, I do not consider to have been unreasonable.

21. Similarly the prudential division took the view that they should not require Equitable to put a 'health warning' on their products. It would not be reasonable to allow Equitable to trade, but then suggest to potential policyholders and annuitants that the company was not a good investment. The prudential regulator had to have regard to the risks to new investors by requiring a company to close to new business if it was not, and had no immediate prospect of becoming, financially sound or meeting policyholders' reasonable expectations. However, the main concern for new investors would be if they believed they had been personally misled as to the state of the company - and that was a conduct of business, rather than a prudential, matter. In the circumstances, I did not consider FSA's decision not to require Equitable to make such a disclosure to have been maladministrative.

22. That raised the question of whether the prudential division had ensured that they had made the conduct of business regulator sufficiently aware of the financial difficulties which Equitable were facing, in order that they could reach an informed view as to what action would be appropriate on their part. I was satisfied that while, with hindsight, the prudential division might on some occasions have underlined even more strongly to their conduct of business colleagues the risks to new policyholders and annuitants if no sale was achieved, the prudential division had kept the conduct of business regulator adequately informed of Equitable's position.

The Treasury's role

23. Although they had contracted out their prudential regulatory functions to FSA, the Treasury remained responsible to Parliament for prudential regulation throughout the period investigated. I was satisfied that the Treasury had retained sufficient in-house expertise in order for them to be able properly to monitor

FSA's effectiveness in carrying out these functions to the standards set in the service level agreement. I was also satisfied that, although there was little documentary evidence of their routine contacts with FSA during this period, the Treasury had kept abreast of the developing Equitable situation and had had regular discussions with FSA about the prudential regulator's position.

Conclusion

24. I have not found any evidence to suggest that the prudential regulator failed to take appropriate intervention action during the period under investigation. Nor have I found any evidence to suggest that the decisions which the prudential regulator made as to what action (both formal and informal) was required of them in relation to Equitable, were either outside the bounds of reasonableness or reached maladministratively. Given the then regulatory framework, the actuarial advice FSA were given, and the legal advice FSA received regarding the proper exercise of their powers, I do not dissent from their view that the prudential regulator could only intervene formally if a company breached the statutory requirements and that, otherwise, their role was to identify problems and issues, and through informal pressure, encourage the company to take the necessary action to get back to a sound financial base.

25. My investigation has shown that FSA monitored Equitable to ensure that they did not breach the regulatory solvency requirements and urged them to take steps to improve their position. They regularly considered whether they had grounds for formal intervention, thought through the likely impact of any regulatory action on policyholders and considered how policyholders' best interests were most likely to be met. While, with the benefit of hindsight, I have identified in my report several occasions when FSA in their role as prudential regulator might have done things differently, I have not found that on those occasions the action that they did take was in itself unreasonable (nor indeed that those actions influenced the overall course of events). I am therefore satisfied that the FSA, acting as prudential regulator on the Treasury's behalf, cannot be said to have acted maladministratively and to have caused the injustice which the complainant alleges. It follows that I do not uphold the complaint.

Treasury guidance made clear that the circumstances were dependent on the bonus policy having been made clear in the terms of the contract and on the life insurer concerned having communicated their policy clearly to policyholders. FSA took the view that, if that had been done, there could be no question of policyholders' reasonable expectations not being met. In my view, that was a reasonable view to take. Further, given the potential significance of the anticipated court ruling to the question of policyholders' reasonable expectations, and in light of the other discussions FSA were having with Equitable at the time, I consider that the decision not to rush to a firm view in advance of the court ruling was also reasonable.

15. The prudential regulator's decision to await the court ruling did not however mean that they did not consider the question of policyholders' reasonable expectations. FSA wanted to ensure that Equitable's financial position had not previously been, and was not then being, misrepresented to potential policyholders. To meet those concerns they pressed Equitable hard on the reserving issue and asked for early submission of their 1998 returns, in which Equitable were required to include specific reserves reflecting their full potential GAR liabilities. The prudential division also referred copies of Equitable's previous bonus notices, which they thought might be misleading, to the conduct of business regulator to determine whether they provided grounds for intervention by them.

Should FSA have predicted the House of Lords' judgment?

16. In my view the fact that FSA did not consider the eventual ruling as a strong possibility, either from the outset or even after the Court of Appeal ruling, did not indicate that they were not carrying out their role effectively. The High Court had of course ruled in Equitable's favour, and further, each of the four judges who had considered the case up to that point had given different reasons for their conclusions. The Court of Appeal ruling had underlined that the issue was not clear-cut and had brought to the fore the issue of ring-fencing of funds, when one judge commented that in his view ring-fencing could be legitimate and would limit the financial impact of an adverse ruling. FSA did not seriously consider the significant ramifications if ring-fencing were not permissible until it became clear during the House of Lords' hearing that that ruling was a possibility. However, it would be wrong to say that FSA were totally surprised by the House of Lords' judgment or ill-prepared for it. The ruling was unexpected, but as it went against much accepted actuarial and industry practice, that was not in itself a sign of poor judgment; and the possibility had featured in both FSA's and Equitable's scenario planning. The fact that FSA's own legal advisers had raised the question of whether ring-fencing could be contrary to GAR policyholders' reasonable expectations might have alerted the prudential regulators earlier to there being a real possibility that the legal view might differ from the actuarial perspective. I do not, however, see that earlier serious consideration of the ring-fencing issue by FSA would have influenced events in any way.

After the House of Lords' judgment (20 July 2000)

17. Equitable's solvency position (because the judgment affected the reinsurance agreement) and the decisions facing the prudential regulator changed dramatically after the House of Lords' judgment. FSA then had to decide whether to close Equitable to new business or to allow them to try to sell the company as a going concern. The prudential regulator's primary objective was to protect existing policyholders' interests by ensuring that Equitable remained solvent and able to meet their liabilities. FSA took the view that Equitable's strategy of seeking a buyer was likely to result in the best outcome for policyholders. Equitable said, and FSA accepted, that a sale could result in Equitable acquiring sufficient funding to repay the seven months of bonus withheld in response to the House of Lords' judgment, and possibly to make a goodwill payment to existing policyholders on top of that. That position could only be achieved - if at all - through a sale.

18. FSA's decision not to take formal intervention action at that time, but to allow Equitable to put themselves up for sale was reasonable as long as there was a good prospect of success. Equitable said, and FSA and many observers believed, that Equitable would easily find a buyer and command a substantial premium. While the regulator was well aware of the financial difficulties facing Equitable, I found no evidence to suggest that FSA should have either considered from the outset that the prospect of a sale was unlikely, or recognised significantly sooner that the sale process would fail. Given initial interest from bidders and Equitable's reputation, FSA could not have justified immediate closure as long as it appeared that the situation was still retrievable. While the potential liabilities arising from further top-up payments into GAR policies were undoubtedly a significant complicating factor, the fact that the three main bidders continued in the sales process for some weeks after they became aware of that issue strongly supports FSA's view that potential top-ups were not in isolation a 'deal-killer'. FSA's papers indicated that a combination of factors caused the bidders to withdraw, not all of which related to Equitable's finances; the bidders' own portfolios and business plans all contributed to their decisions.

19. That still left the question, however, of whether the prudential regulator should have stopped Equitable taking on new business after the House of Lords' ruling. FSA took the view that maintaining the value of Equitable was in the best interests of current policyholders, and that closing Equitable to new business would damage the Society's value and probably eliminate the prospect of a sale. That view was supported by professional advice I received. FSA saw a need to balance the interests of new and existing policyholders and had decided that the balance was overwhelmingly in favour of Equitable continuing to write new business as all policyholders - new and old - would have benefited from a successful sale, and Equitable's withholding of seven months' reversionary bonus meant that new policyholders were not being asked to subsidise the costs arising from the House of Lords' ruling. It was, and remains, the responsibility of companies to make explicit the risks to potential and

but not eliminate, the risk of company failure by identifying early signs of trouble, and taking preventative action."

12. It is not for me to comment on whether or not the statutory provisions (as set out in the Insurance Companies Act 1982 and the Financial Services Act 1986), in establishing such a regulatory regime, are or were appropriate. That was, and is, a matter for Parliament itself. However, it is important to recognise that the nature of the regime established to protect policyholders determined what the FSA could and could not do in relation to Equitable. It is clear to me from my investigation that the framework within which the prudential regulator was required to work simply did not envisage or allow for the sort of intervention into a company's affairs which complainants have contended should have happened in this case.

13. I am, of course, aware that, with the enactment of the Financial Services and Markets Act 2000, the regulatory system has changed since the events in question. Whether statutory regulatory regimes meet the expectations - reasonable or otherwise - of consumers or are otherwise appropriate are matters for Parliament. It is not, therefore, for me to say whether the new regime has bridged that gap or indeed should seek to do so. I can only draw Parliament's attention to what I perceive to be a fundamental mismatch between public expectations of the prudential regulator's role and what the regulator could reasonably have been expected to deliver.

14. When, on 29 October 2001, my predecessor announced that he was starting this investigation, he also announced his intention to await the outcome of the wider Penrose Inquiry before deciding whether or not it would be appropriate for this Office to look at the period before 1 January 1999. I have the very deepest sympathy for those who have suffered financial loss as a result of the events relating to Equitable, and I can understand how very distressing the situation in which they now find themselves must be. However, in light of my findings in respect of the period covered by my investigation and the observations I have made in this report, I cannot see what would be gained from my further intervention in the matter. Further, if I were to investigate an earlier period, given my very limited remit, I do not believe that I would be able to meet the expectations of policyholders in terms of the remedies that they are seeking. I consider that I would be offering policyholders false hope were I to suggest otherwise. I have decided, therefore, to exercise my discretion under the 1967 Act not to investigate further complaints about the prudential regulation of Equitable.

Appendix: Summary of findings

Case No. C.1597/01

The prudential regulation of Equitable Life

The complaint

1. Mr P complained to my predecessor that the Financial Services Authority (FSA), acting on behalf of the Treasury, failed to take appropriate regulatory action which would have ensured that existing and potential policyholders were able to make fully informed decisions when purchasing policies or annuities from the Equitable Life Assurance Society (Equitable). As a result, Equitable were able to continue to encourage him, and other investors like him, to purchase a with-profits annuity without a full understanding of the risks involved. He contended that, had he been aware of the true position, he would not have purchased such an annuity in June 2000. Having purchased the annuity, he was unable to transfer it to another insurer without penalty. He sought full redress.

The investigation

2. The investigation began in December 2001 after my predecessor had obtained the comments of the Permanent Secretary at the Treasury. On taking up the complaint for investigation, my predecessor decided to limit the period under investigation to that from 1 January 1999, when FSA began to conduct the prudential regulation of life insurance under contract from the Treasury, to 8 December 2000, when Equitable closed to new business. On taking up post in November 2002 I carried out a careful review of the position and decided not to depart from my predecessor's decision. I have, however, of necessity had to look back at some of the earlier events in some detail to understand the background to the period under investigation.

Jurisdiction

3. The significant restrictions on my jurisdiction in this matter are set out in detail in paragraphs 3 to 6 of the full text of my investigation report (see Part II of this Volume). I should however emphasise here that FSA fall within my jurisdiction only in so far as they were acting on behalf of the Treasury as **prudential regulator** before 1 December 2001. I have no legal powers to investigate Equitable, the conduct of business regulators or the various professional bodies or advisers involved; nor may

I question the merits of a discretionary decision taken without maladministration.

Evidence

4. During the course of my investigation my officers examined documents held by FSA, the Treasury, the Government Actuary's Department (GAD), and the conduct of business regulators in so far as they related to the prudential regulation of Equitable. They also interviewed a number of officers who had been involved with these events, including then members of FSA, the Treasury, and GAD. Equitable also submitted some specific papers requested by my officers. I have also obtained advice from an independent senior actuary. The detailed account of the prudential regulators' actions in relation to Equitable is set out in the chronology of events in Part II of this Volume; a summary of the officers' evidence is included in paragraphs 104 to 160 of the investigation report.

Findings

5. I found that FSA as prudential regulator constantly had to assess and reassess whether they had grounds for taking formal regulatory action in respect of Equitable. As any intervention was likely to have a significant impact on Equitable's future profitability and even viability, and could therefore impact adversely on policyholders and would probably provoke legal challenge, it was not action to be taken lightly. Furthermore, Equitable were a long-standing, successful, high-profile and still growing company; they were highly regarded and a market leader. Although they were inherently weak financially, because of their policy of not holding back substantial free reserves and of distributing as much as possible to policyholders, Equitable had made no secret of that policy, which had been a key feature in their publicity and marketing strategy. The inescapable consequence of that policy, which they also publicised widely, was that policyholders would follow the company's fortunes. That relative 'weakness' was not of itself therefore a reason for intervention, as policyholders were well aware of it.

6. When FSA began to operate as the prudential regulator on 1 January 1999, there were two key issues that they had to address: first, the basis upon which Equitable were reserving for their significant potential liabilities arising from the guaranteed annuity rate (GAR) options contained within their individual and group personal pension plans; and, secondly, the differential terminal bonus policy used to manage the actual GAR liabilities arising, and whether that policy met policyholders' reasonable expectations. Either of those issues could have provided grounds for the prudential regulator's intervention.

Regulatory solvency

7. There is no doubt that in late 1998 the Treasury had briefed FSA in considerable detail about Equitable's weak regulatory solvency position and had indicated a possible need for the regulator to intervene if Equitable either: a) continued to refuse to accept the need to reserve to the level GAD thought appropriate to cover the

GAR liabilities, or b) declared a bonus without the regulator's prior agreement. However, that position stood to be resolved, at least to an extent sufficient to satisfy FSA's requirements in relation to reserving, by a reinsurance agreement Equitable were in the process of negotiating. By 1 January 1999, when the FSA took over as prudential regulator, the situation had therefore moved on sufficiently for the Treasury's earlier indications of a possible need for immediate intervention to be regarded as no longer valid.

8. Nonetheless, my investigation found that it was certainly not true to say that FSA knew that Equitable's position needed to be closely monitored and did nothing. The prudential regulators could certainly not be criticised for a lack of concern about Equitable and the position of their policyholders. There was considerable discussion about Equitable's situation and about the level of intervention required - and what could be legally justified - on the prudential regulator's part. There were also numerous exchanges and meetings with Equitable as FSA's prudential division, with GAD's support, tried to ensure that Equitable secured adequate reserves and did not worsen their solvency position.

9. FSA continued throughout to insist that Equitable conform to their full reserving requirements in the face of strong resistance from Equitable. They also strongly urged Equitable to be cautious about the bonuses they paid in 1999 (warning Equitable that they would use their powers to intervene if Equitable attempted to declare a bonus before FSA were satisfied that they had sufficient reserves in place). In March 2000 FSA did not query the 5% annual bonus declared, in contrast to the considerable wranglings of the previous year, but the bonus payment was in essence a commercial decision for Equitable (and fully in line with their publicised policy of maximum distribution of surpluses). As long as that did not cause Equitable to breach regulatory solvency (which it did not) then FSA had no basis for formal intervention on solvency grounds.

10. There was also the question of whether it was appropriate in the circumstances for the prudential regulator to allow Equitable to rely heavily on reinsurance and on a future profits implicit item (that is taking credit for anticipated future returns from current business) effectively to balance their books, given that these might be regarded simply as technical ways of satisfying the regulatory solvency requirements which did nothing to improve Equitable's underlying financial position.

11. Reinsurance was an accepted actuarial practice in the insurance industry, and GAD confirmed that it could be used to improve Equitable's regulatory solvency position. Given that advice, it was reasonable for FSA to accept the use of reinsurance in Equitable's case. Further FSA, working closely with GAD, took an active interest in the terms of the agreement and suggested to Equitable a number of amendments to the terms to make the reinsurance as robust as possible and, most importantly, to ensure that it was subordinate to policyholders' interests. Although the agreement was only signed some

time after it was deemed to take effect, I received expert advice that that was not unusual within the industry and that the reinsurers would have been on risk (i.e. they would honour the agreement) once the terms had been agreed.

12. From 1994 onwards Equitable used increasingly larger future profits implicit items in their accounts. I accept FSA's view that the increase was broadly proportionate to the growth in Equitable's business and so did not necessarily point to underlying financial weakness. I note also that the most significant increase in the sum applied for was specifically to meet the prudential regulator's insistence that Equitable reserve fully for their potential GAR liabilities. Further, the sums sought were much lower than those for which they had been entitled to apply under the regulations. That being the case, again I do not see how the Treasury and their FSA advisers could reasonably have refused Equitable's applications. I considered whether a further application made shortly before the House of Lords' judgment in June 2000 should have attracted closer scrutiny in September 2000, particularly as the recommendation to the Treasury was based on advice to FSA from GAD which appeared to predate the Lords' judgment. However, I accept the accounts of GAD and FSA officers that they had reconfirmed that their earlier advice remained valid, and that the prudential regulator could not reasonably have recommended refusal.

Differential terminal bonus policy and policyholders' reasonable expectations

13. Another possible ground for intervention was if the prudential regulator believed that Equitable were unable to meet 'policyholders' reasonable expectations'. This regulatory concept had no clear legal definition at the time and was not straightforward. There was no indication in the relevant legislation as to how companies were to balance the differing expectations of different groups of policyholders (for example, those of GAR and non-GAR, and of existing and new policyholders), particularly when meeting one group's expectations would impact adversely on the expectations of others. That balance was all the more difficult for Equitable, because they had neither significant uncommitted reserves (sometimes called free estate) nor shareholders to ask for more cash.

14. While FSA recognised that they needed to address the question of whether Equitable's differential terminal bonus policy met policyholders' reasonable expectations, they concluded that there would be little point in trying to reach a firm view on the matter until the court had given a final ruling on that policy. (Equitable had initiated a test case in the courts to determine whether they had the right to declare differential terminal bonuses depending on whether the policyholder took up a GAR annuity option or not.) FSA's decision to await the court's judgment was undoubtedly influenced by their view, in line with Treasury guidance of 18 December 1998, that there were legitimate arguments in support of the differential terminal bonus policy in certain circumstances. Was that so misguided a view that it might be considered to be maladministrative? I do not believe so. I note that the