

HOW THE FINANCIAL SERVICES AUTHORITY AND THE TREASURY BETRAYED EQUITABLE'S POLICYHOLDERS

A paper by Alex Henney¹

“My government is committed to openness and accountability...”

The Queen's Speech, 6 November 2007.

SUMMARY AND CONCLUSIONS

1. What we have to tell is the story of the lengths to which the Financial Services Authority (FSA) and the Treasury went to keep the Equitable afloat in order to protect the government from having to pay any compensation for its incompetent regulation of Equitable over more than a decade.

The means of achieving these ends were:-

- i) Maintaining the line that Equitable was solvent, which was achieved in part by actuarial flummery, notably the use of a valueless reinsurance treaty which at various times was valued at between £1098m and £250m when in fact it was worthless. **The Parliamentary Ombudsman found “the failure by the FSA, acting on behalf of the prudential regulators, (i) to ensure that the financial reinsurance arrangement was not taken into account within the Society's 1998 returns without an appropriate concession being given, and (ii) to ensure that the credit taken by the Society within its returns for 1998, 1999, and 2000 properly reflected the economic substance of that arrangement, constitutes maladministration”.**
- ii) Another component to maintaining solvency was to devalue the liability that policyholders without guaranteed annuity rate options (non-GARs) could claim for mis-selling. It started at several £ billions in July 2001, when the FSA and Equitable received solid legal opinions on mis-selling, and this almost led to Equitable either going into administration or the government being asked for £4-5 billion to restore its finances. By September the sum had been whittled down to £220 million.
- iii) Notwithstanding the FSA's duty under the Service Level Agreement with the Treasury and subsequently under the Financial Services and Markets Act 2000 to “secure the appropriate degree of protection for consumers” and “the needs that consumers may have for advice and accurate information” it kept policyholders in the dark about the financial situation of

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Equitable. The Parliamentary Ombudsman considered of the period following closure of Equitable to new business in December 2000 “that the misleading information, about the Society’s solvency position and its record of compliance with other regulatory requirements, that was produced by the FSA, acting on behalf of the prudential regulators, during the period after the Society closed to new business, constitutes maladministration”.

- iv) Blocking off legal redress for mis-selling by encouraging the non-GAR policyholders into signing a Compromise Settlement under S425 of the Companies Act against their interest. They were offered an uplift of 2½% on the value of their policies. The FSA should have known this offer could not be honoured from the fund available.
- v) Endorsing a second Compromise in which a trivial amount was to be offered to expunge the legal rights of 70,000 former policyholders who had left before the Compromise. But when threatened that the Equitable Late Joiners Action Group would go to court and expose what was going on in court, it backed down. The Equitable Late Joiners Action Group eventually received adequate compensation.
- vi) Blocking policyholders’ avenues of redress. The FSA:-
 - Squashed the Personal Investment Authority’s wish to fine Equitable for mis-selling drawdown policies
 - Aborted the Office of Fair Trading’s inquiry into Equitable’s imposition of Market Value Adjustments
 - Got the Financial Ombudsman’s Service (FOS) – which claims to be independent, but is in reality a subsidiary of the FSA – to toe the line to support Equitable rather than policyholders with complaints. The FOS first delayed decisions; then ensured that any awards against Equitable were modest and opaque; and finally the Chief Ombudsman refused to consider complaints about overbonusing which emerged from the report prepared by Lord Penrose at the request of the government. And this notwithstanding the statement by Ruth Kelly in the House of Commons that “I want to make it clear to the House that we stand ready, if requested, to assist the financial ombudsman in expediting the resolution of these [i.e. Penrose related] complaints”
 - Aimed (as revealed in the Parliamentary Ombudsman’s chronology on 30/08/2001) to leave the courts as the only avenue open to policyholders to complain. This was done in the full knowledge of the financial cost and risks involved in taking on the deep pocket of Equitable, which funded aggressive City lawyer Lovells. Their opening gambit in cases was that claims had no chance, and claimants would end up paying their costs which would be very substantial. For many, particularly elderly, people this is too daunting a prospect. Nonetheless several groups and some individuals did win from out-of-court settlements adequate recompense for their losses; in all cases there was a confidentiality agreement as part of the settlement. *The FSA and FOS let the little people swing*
- vii) Delay. At the “macro” level the government’s first tactic was to ask Lord Penrose to go away and prepare a history of what happened against terms of references which carefully excluded

him from apportioning any blame. From appointment to publication took 30 months in February 2004, three and a quarter years after Equitable closed for new business. When the Parliamentary Ombudsman commenced her investigation in July 2004, she hoped to report in two years. The Treasury and FSA delayed it in two significant ways – first in August 2006 the FSA found numerous previously undisclosed documents; second when she sent a first draft of her report for maxwellisation in January 2007 the Treasury took 3 months and produced a report of 550 pages of criticisms. Her report was published on 17 July 2008 – seven and two thirds years after Equitable closed for business. Among her many criticisms the Parliamentary Ombudsman observed that “The failure at the outset to establish a single inquiry which was not hampered by terms of reference or a statutory jurisdiction which limited the issues that could be addressed has resulted in such an extended and long drawn out process”². *That failure was planned by the Treasury.* At the micro level, the FSA and FOS have done everything to delay resolving complaints. *Justice delayed is justice denied particularly when many elderly pensioners have died.*

2. Most of the dramatis personae in this shabby tale have moved on, either to civil service cost indexed pensions courtesy of the taxpayer, or to other roles which are either comfortable or profitable. The FSA subsequently failed the regulation of Northern Rock for several of the same reasons that it failed the regulation of Equitable. Various professionals have feasted on Equitable policyholders; the abortive legal case that Equitable ran against the former directors alone cost policyholders £45m in professional fees. As is customary in British financial scandals, the little guys get stuffed.

BACKGROUND

3. This paper mainly draws on “Part three: chronology of events” of the Parliamentary Ombudsman’s Report. The dates of events are either mentioned as XX month 200Y or [XX/mt/200Y]. In addition it draws on the report prepared by Ronnie Baird, the Former Director of Internal Audit of the FSA³, and an opinion written by Lord Neill of Bladen, the former Commissioner of Parliamentary Standards, for the Equitable Members Action Group (EMAG) on the performance of the Financial Ombudsman Service⁴.

4. On 1 January 1999 the FSA assumed responsibilities from HM Treasury for undertaking the regulation of insurance companies under a Service Level Agreement that was signed by HM Treasury

² Her report lists 9 inquiries, reviews a court case, and disciplinary hearings. The references to an inquiry hampered by term of reference is presumably to the Penrose Report, which the government set up within a carefully prescribed framework; the reference to an inquiry not hampered by statutory jurisdiction referred to her inquiry, which could not look at conduct of business regulation nor go beyond 1 December 2001.

³ The Report of the Financial Services Authority on the Review of the Regulation of Equitable Life Assurance Society from 1 January 1999 to 8 December 2000, which Her Majesty’s Government is Submitting as Evidence to the Inquiry Conducted by Lord Penrose, 16 October 2001, HMSO.

⁴ <http://www.emag.org.uk/documents/LordNeillReport/NeillOpinion.pdf>.

on 18 December 1998. Schedule I of the Agreement defines the Service Standard Specification. Paragraph I states that in May 1997 the Chancellor of the Exchequer announced the Government's intention to create a unified financial services regulatory body. The draft legislation published on 30 July 1998 (which became the Financial Services and Markets Act 2000, FSMA) specifies the FSA's objectives including:-

- "Maintaining confidence in the financial system" which became S3(1) of the FSMA

Comment: to a degree the problems that beset Equitable, and the serious shortcomings in the way that the FSA and government handled them, reduced people's confidence in saving for their pensions

- "Promoting public understanding of the financial system" which became S4(1) of FSMA

Comment: if the fiasco promoted public understanding, it did in a way that increased mistrust of the life insurance industry and regulation by the FSA (subsequently reduced still further by the Northern Rock fiasco)

- "Securing the appropriate degree of protection for consumers", which became S5(1) of FSMA. S5(2) states that "In considering what degree of protection may be appropriate, the Authority must have regard to several matters including in S5(2)(C) the needs that consumers may have for advice and accurate information"⁵

⁵ The FSA has reiterated its commitment to provision of information. Its Principle 7 "Communication with clients" states "A firm must pay due regard to the information needs of its clients, and communicate information to them in a way in which is clear, fair and not misleading". One of its papers observes:

"This means we need to consider issues such as what information is needed for . . . achieving better information about firms for consumers. . .".

"Public disclosure of information about financial institutions helps actual and potential consumers of financial services products and other market participants to understand the financial position and strength of the institutions they are dealing with. For consumers, the availability of this information allows them to make better informed decisions and choices. However, consumers may not make this assessment alone, since in many cases they will rely upon information/sophisticated users, such as the media, agents and brokers, independent financial advisers and the like, to give them relevant information to address their needs. To this end, information that is publicly disclosed needs to be relevant, reliable and easily accessible. So, the data being collected should be targeted to achieving information that gives a clearer picture of a firm's financial well-being, and is in line with the principles of good information."

Another of its documents identifies strategic aims including:-

- "consumers should be better able to make informed choices and achieve fair deals in their financial dealings",
- consumers should be able to secure a fair deal through:
- "requiring firms to treat customers fairly, during and after the point of sale, for example by giving clearer and fairer information;
- equipping consumers to make informed decisions, for example through improved product disclosure and consumer education initiatives".

Comment: One of the Parliamentary Ombudsman’s findings was “that the misleading information, about the Society’s solvency position and its record of compliance with other regulatory requirements, that was produced by the FSA, acting on behalf of the prudential regulators, during the period after the Society closed to new business, constitutes maladministration”. The FSA did not fulfill its obligations to policyholders either to protect them or to meet their needs for advice and accurate information. It ignored this duty in order to keep Equitable as a going concern when in fact it was insolvent, in order to avoid exposure of the shortcomings of regulation, and to protect the government from claims for compensation. None of these objectives were part of its duties.

5. A crucial part of the FSA’s strategy was to claim that Equitable was solvent from a regulatory perspective, beginning in January 1999 with the saga of the valueless reinsurance treaty which the Parliamentary Ombudsman analyses at length as does the submission by EMAG. But as we will see this was merely the tip of the iceberg.

6. The Chronology reveals that the then Chancellor, Gordon Brown, was informed at various stages about the situation. The FSA updated him on 01/02/2001. On 20/07/2001 there was a report to Brown which referred to possible administration. When there was concern that Equitable might be insolvent the Treasury informed the FSA that Brown “holds a policy with a company linked to Equitable (University Life) and may be conflicted from taking decisions on the company” [26/07/2001]⁶. Nonetheless, four days later on 30 July 2001 Brown was asked to consider the following [29/07/2001]:-

- the current situation. [FSA’s Chairman’s] letter
- policy holder protection, article 4 and options
- administration and options
- the review ([an official’s] submission of [27 July 2001])
- the case for government support
- the “package” which should accompany the [Counsel for Equitable] opinion’s publication on 20 August
- in the light of the above, the government’s “stance” and priorities on Equitable.

On 2 August 2001 he was sent the minutes of the Tripartite Standing Committee (FSA, Treasury, Bank of England) held on 31 July 2001.

⁶ The square bracketed dates refer to dates in the Chronology.

7. The Chronology shows that the FSA de facto acted as a shadow director of Equitable⁷, to a significant degree pulling its strings and in particular was heavily implicated in the Compromise which was proposed in September 2001 and endorsed by the court in February 2002. The Compromise was a settlement under S425 of the Companies Act between the creditors of a company and a company. In this case the creditors were the policyholders, and for the purposes of the Compromise they were divided into just two groups – policyholders who had a guaranteed annuity rate option (GARs), and those who did not have a GAR (non-GARs). The purpose of the settlement was essentially to limit the financial entitlement of the GARs, and perhaps more importantly to expunge the rights of the non-GARs to seek compensation for mis-selling because they had not been informed of the prior rights of the GARs. The non-GARs were about three quarters of the number of the with-profits policyholders and owned about three quarters of the with-profits fund.

8. The story starts immediately after the House of Lords decision, with the FSA's cavalier treatment of policyholders who subsequently joined Equitable. Then:-

- it emasculated the Personal Investment Authority (PIA) and squashed its investigation into mis-selling of drawdown policies
- it aborted the Office of Fair Trading's investigation into complaints about Equitable's imposition of a market value adjuster
- it ensured that the Financial Ombudsman Service toed the Treasury's line

AFTER THE HOUSE OF LORDS DECISION

9. The first glaring failure of the FSA was that it appeared to make no attempt to get proper independent legal advice from an outside lawyer on the House of Lords ruling, which was manifestly unfair to non-GAR policyholders, and appeared to make no attempt to get the decision overturned by legislation if needs be. Next it allowed Equitable to remain open for new business and 18,900 new policyholders (of whom 46% were with-profits) joined after the House of Lords judgment [18/12/2000]. Also some existing policyholders invested further sums in their policies. When asked

⁷ We read on 19 July 2001 'On the conversation with Thomson, FSA's Head of Life Assurance says that he was in 'emotional mood' and said that 'if the FSA wanted to run the Equitable, then they were welcome to do so, and he would join Peter Nowell in resigning'. The FSA's Head of Life Insurance says that he stressed that 'although what we were proposing was unusual by the traditions of DTI/HMT insurance regulation, it was perfectly normal in the context of banking supervision, and as an integrated regulator, it was natural for the FSA to review the full range of supervisory tools available (and familiar) to it'.

in the Parliamentary Ombudsman's first report⁸ why the prudential regulator had not required Equitable to close to new business, the Head of Prudential Supervision said "that this was because to do so would be very damaging to the value of the company and possibly fatal to the prospects of a sale. A balance had to be struck between the interests of new and existing policyholders...Furthermore new policyholders could be compensated if they sustained a loss as result of joining on the basis of misleading information" (para 147). The FSA never *did* anything for these very late joiners who were hit with a 16% reduction in policy values on 16 July 2001 and then 4% on 15 April 2002, 6% on 1 July 2002, and a market value adjuster⁹ up to 10% if they left the fund. Penrose criticized the failure of the FSA to protect these policyholders, as did the Parliamentary Ombudsman. **More broadly she considered "that the unsound basis on which the decision was taken by the FSA, acting on behalf of the prudential regulators, to permit the Society to remain open to new business, following its loss of the Hyman litigation, constitutes maladministration. I therefore make such a finding of maladministration against the FSA".**

EMASCULATING THE PERSONAL INVESTMENT AUTHORITY (PIA)

10. On 1 June 1998 the staff of the PIA were transferred to the employment of the FSA, and in practical terms the FSA assumed the responsibilities of the PIA, which were undertaken by its Investment Business Division. Two themes run through Chapter 5 of the Baird Report, which describes the Conduct of Business regulation of Equitable. The first is that the FSA had a marked disinclination to intervene, even when it had identified a need to do so, with the result that it is far from clear that the existence of the regulatory regime made any practical difference to the conduct – and misconduct – of the affairs of Equitable. Baird's report includes many comments made by, or about, the FSA's Conduct of Business Regulation such as:

- What if anything to do to "at least justify a stance of non-involvement".
- "Is there at least enough for a meeting"?
- "My general feel is that Enforcement do not have an appetite for this one".
- "Is there anything we should now be doing on this? I know we were going to about a year ago (my delay) - has the time passed?"

The second is that there was little or no coordination between the part of the FSA responsible for prudential regulation (IFSD) and the part responsible for conduct of business regulation.

⁸ The Prudential Regulation of Equitable Life, The Parliamentary Ombudsman, HC809-II, 30 June 2003.

⁹ A market value adjuster is a discount applied to policies on non contractual termination. During the 1990s Equitable had not often applied a market value adjuster, but after the House of Lords judgment it imposed one.

11. After the House of Lords decision Equitable mounted an energetic marketing campaign which worried a number of members of the public and journalists, who complained. Baird set out PIA/IBD's handling of the issue:-

- “As for advertising, the IBD did not pay any special attention to Equitable Life's advertising after the House of Lords' judgment but, between the House of Lords' judgment and the closure to new business on 8 December 2000, certain complaints were forwarded to IBD in connection with Equitable Life's advertising” (5.30.2)¹⁰
- “On 13 November 2000, IBD and IFSD were informed by Media Relations that newspapers had contacted the FSA about Equitable Life suggesting that there would need to be regulatory intervention if a buyer could not be found. The line that had been given by the FSA to the press was that, on present information, a profitable run-off was the worst that could happen and there was no disaster in the making” (5.30.10).
- “I don't think we should show anything but disinterest [sic] in response to public enquiries – it is a matter for the company”. IFSD also approved the FSA line to be used if there was no successful bid, stating “If we say anything else, we will simply be asked why we have not intervened already to protect policyholders in case a bid fails” (5.30.11)

As someone so rightly observed to Baird, “The IBD tradition is at the more passive end of the supervisory process. The nature of their supervision...is much more reactive than proactive” (2.30.2).

12. In October 2000 the PIA were thinking of disciplinary action and a fine of £500,000 in respect of Equitable's mis-selling of income drawdown¹¹ policies because its sales process was ‘significantly defective’ [27/10/2000]. Equitable met the PIA to discuss the position [27/11/2000]. An FSA line manager attended the meeting and subsequently wrote to the FSA's Head of Life Insurance to set out what happened. He explained that prior to the meeting he spoke to PIA's Enforcement Department:

‘... to alert them to our concerns 1. that regulatory action, and in particular punitive fines, would be detrimental to the interests of policyholders, and 2. The potential for regulatory action to disrupt - or even destroy - the sales process. The points were taken but they seemed uncomfortable with the idea that they should take such factors into account’.

¹⁰ The round bracketed numbers in this section are the paragraph numbers in Baird's report.

¹¹ Drawdown policies allow pensioners to draw limited income while supposedly preserving their capital so as to (hopefully) enjoy the benefit of a with-profits fund. In fact in post 1998 contracts, hidden in the small print, was a provision to convert the policyholders' guaranteed fund into an entirely non-guaranteed fund over a period of twelve years, and then it could be written down at the stroke of a pen. They are not suitable for people who have a fund of less than £200-250,000, yet they were being sold to people with pension funds of less than £100,000. In the 2001 Accounts Equitable allowed for provisions of £80m for mis-selling of draw-down schemes

13. The PIA insisted to Equitable that it must review sales of past income drawdown policies [04/12/2000]. On 18 January 2001, after Equitable had closed to new business, the FSA met with the PIA to discuss enforcement issues. “[FSA’s Head of Life Insurance] was concerned that any disciplinary action could harm the delicate sales process¹² and any goodwill payment which would be in the overall interest of policyholders. [The Head of Life Insurance] outlined the sensitivities and the proposed sales timetable”.

14. The PIA then raised the question of those who had joined after the Court of Appeal judgment in January 2000 [26/01/2001]. At that time the Halifax was negotiating to buy part of Equitable and was concerned about a possible public reprimand by the regulators [28/01/2001]. The next day Halifax insisted that disciplinary action by the PIA be called off [29/01/2001]. The PIA backed down over the issue provided that Equitable took remedial action [30/01/2001].

Game set and match to the FSA – policyholders lose.

ABORTING THE OFFICE OF FAIR TRADING (OFT) INQUIRY

15. Some policyholders complained to the OFT about the imposition of a market value adjuster (MVA) by Equitable to non-contractual terminations of policies. The OFT wrote to FSA ‘We are considering whether we need to take enforcement action in relation to reports that Equitable Life has imposed a new charge of 10% on transfers of assets out of the Society. We are beginning to receive complaints and enquiries about this charge. The relevant terms and conditions could be unfair if they give the Society discretion to make new charges or to vary existing ones’ [12/12/2000].

16. On 7 February 2001 the FSA wrote to the OFT at length arguing that the Unfair Terms of Contract Act does not apply to MVAs. The OFT replied on 15 February 2001 disagreeing strongly.

17. On 3 April 2001 the Office of Fair Trading wrote again saying they were taking enforcement action against Equitable and requesting the assistance of the FSA. On 17 April 2001 the Chairman of the FSA wrote to the OFT pointing out that under the new legislation complaints made to the OFT would be taken over by the FSA which they would be happy to do so. On 7 June 2001 the FSA met the OFT and took away their Equitable file. The entry concludes “There is no action for FSA”. In a

¹² The “sales process” referred to buying pieces of Equitable.

note on 16 July 2001 an FSA line manager confirms that no further action is going to be taken in respect of these complaints about MVAs.

Again, game set and match to the FSA – policyholders lose.

GETTING THE FINANCIAL OMBUDSMAN SERVICE TO TOE THE GOVERNMENT’S LINE

The FOS as a subsidiary of the FSA

18. One of the most unpleasant episodes was the behaviour of the Financial Ombudsman Service (FOS) in dealing with complaints against Equitable. The FOS was set up under Part XVI of FSMA to replace a number of Ombudsmen schemes dealing with complaints against organisations regulated by the FSA. Section 225 of FSMA states that a scheme is to be established “under which certain disputes may be resolved quickly and with minimum formality by an independent person”. The FSA was required to establish a corporate body, whose chairman is appointed and removed by the FSA acting with the approval of the Treasury, and a board whose members are appointed and can be removed from office by the FSA. At least once a year the FOS (and separately the Chief Ombudsman) must report to the FSA on the discharge of their functions. The FSA sets the FOS’s budget and determines how it receives its costs, which is in part by a general levy on regulated companies and in part from companies who have cases brought against them. The FSA also writes the rules by which the FOS functions, which include DISP 2 and DISP 3¹³.

19. Section 14(3)(c) Schedule 17 of FSMA allows an Ombudsman to dismiss complaints for several reasons including 1) if “legal proceeding has been brought concerning the subject matter of the complaint and the ombudsman considers the complaint is best dealt with in these proceedings”, and 2) he “is satisfied that there are other compelling reasons why it is inappropriate for the complaint to be dealt with under the ombudsman scheme”. DISP3.3¹⁴ of the FSA Handbook gives the Ombudsmen discretionary power in further circumstances to dismiss a complaint without considering its merits.

20. The FSA and FOS signed a Memorandum of Understanding in July 2002 which, among other things, states that “The directors of the company must be appointed on terms which make the Financial Ombudsman Service accountable to the FSA in a number of significant respects. In the

¹³ See The Full (FSA) Handbook on www.fsa.gov.uk. DISP stands for Dispute Resolution: Complaints. DISP2 is “Jurisdiction of the Ombudsman Service” and DISP3 is “Complaint handling procedures of the Financial Ombudsman Service”.

¹⁴ DISP3.3 is Dismissal of Complaints Without Consideration of Merits.

interests of both consumers of financial services and the financial services industry, the FSA and the Financial Ombudsman Service will seek to maintain strong and constructive relationships with each other in order to contribute to the efficient functioning of the regulatory system in general and the ombudsman scheme in particular.” Lord Neill pointed out (46)¹⁵ the fact that the FSA was to “receive regular reports from the FOS on the discharge of its functions, suggest a structural superiority of the FSA and a corresponding inferiority of the FOS which might be hard to reconcile with real independence”. *The FOS’s website claims “The ombudsman service is completely independent” - this is not true.*

21. Initially the Chief Ombudsman was concerned that he was not getting the information he needed about Equitable, but as the Compromise was being developed on 30 August 2001 the PIA indicated that it would be necessary to ensure the compliance of the Financial Ombudsman Service:

‘...To head this one off we would have to get the FOS to sign up to our position (which I would have thought they could do without compromising their freedom to look at each case individually). *That would leave the courts as the only alternative avenue still open’ (italics added).*

‘The attached could be laced with more explicit warnings that the society can/could stand only so much financial strain before insolvency beckoned, including as a result of any “better deal” from the FOS. The problem here is that attention could turn to an industry *(or even Government)* bail out’ *(italics added).*

‘We can only decide what to say and how far to go once we have crystallised the outcome we want from the compromise agreement *and whether or not we have a chance of getting the FOS to buy-in to our position as set out in the attached’ (italics added).*

22. A meeting was held on 10 September 2001 between the FSA and the FOS. FSA’s note records:

‘FOS said that they had just over 400 complaints about mis-selling by Equitable (these were “converted” cases, which had been accepted as complaints for FOS to deal with). Most complaints related to a period during and after the litigation, and were from non-GAR policy holders who complained that their potential exposure had not been disclosed. FOS had “parked” these complaints, on the basis that it was not sensible to deal with them while other enquiries (such as the FSA’s independent enquiry) were proceeding. *They were keen to continue to put on hold applications in the pipeline, and to dissuade new claimants coming forward, until there was a clearer basis on which to decide on how to proceed’ (italics added).*

¹⁵ The round bracketed numbers in this section refer to the paragraphs in Lord Neill’s report.

23. The FOS received over five thousand complaints about Equitable which it dealt with at a leisurely pace¹⁶. Thousands of complainants were allocated to a degree arbitrarily to one of four test cases for late joiners. Although the four test cases were contested by leading City solicitors Lovells acting for Equitable (who repeatedly asked for more time), the complainants were not afforded any legal advice. Although the FOS commissioned counsel who recommended that late joiners should receive more than Equitable's inadequate offer of 5%, it nonetheless forwarded, on the Equitable's behalf, the 5% offers. It appeared to have been acting as a partial advocate for Equitable, rather than as an adjudicator, in sometimes rebutting claims off its own bat without even referring back to Equitable.

Fobbing off Penrose related complaints

24. In Parliament on 8 March 2004, responding to publication of the Report by Lord Penrose which among other things found that for many years in the 1990s Equitable had "over-bonused" (i.e. distributed bonuses in excess of its asset values) and consequently had weakened the fund to the tune of £1.8bn, Ruth Kelly, then the Financial Secretary, stressed the role of the FOS, commenting:-

¹⁶ To give an example cited in evidence on 25/4/06 to the European Union Committee of Inquiry into the Collapse of the Equitable Life Assurance Society, by Paul Weir, Secretary of the Equitable Late Contributors Action Group.

"In the middle of 2001 a man called Willi Deppe complained to the FOS which then proceeded to sit on his complaint until it was overtaken by the Compromise.

Mr Deppe wrote to me to explain what has happened.

"I had exhausted the complaints procedure with Equitable Life by about May 2001 and it was Equitable Life who pointed me in the direction of the FOS as final arbitrator. I complained to them and stated that With Profits annuities instigated by Equitable Life in January 2001 had been misrepresented by virtue of the fact that information relating to the existence of GAR's and the liability they had created had been concealed.

The FOS were initially reluctant to examine the complaint on the basis of "pressure of work". They then lost the complaint, then I had used the wrong form etc. They finally acknowledged the complaint "as one they could look at".

The complaint was then passed around the office and I sensed it was being passed 'upwards'. I was then advised by Jane Whittles that Equitable Life had applied for their Compromise and they would not look at my complaint in advance of the voting. I complained immediately that my business was with the FOS in relation to a complaint about an existing complaint concerning Equitable Life which they had acknowledged. The FOS, in the full knowledge of what Equitable Life were doing, refused to budge.

They now claim my complaint was Compromised by the Compromise. They have never once made any comment about the actual subject that formed the basis of the complaint that I presented to them in 2001".

68 “Further this Government has also provided for a single Financial Services Ombudsman to consider individual complaints. I understand that he is currently considering the cases of a number of different categories of former policyholders who have made claims for redress, for which the society has already made provisions.”

69 “I want to make it clear to the House that we stand ready, if requested, to assist the financial ombudsman in expediting the resolution of these complaints.”

82 “We stand ready if requested to assist the financial services ombudsman in the resolution of any consequential issues before him and his staff.”

25. After she had concluded her statement there were a number of interventions by MPs concerned at how the Equitable disaster was affecting their constituents. She gave reassurance to four MPs stressing the availability of the FOS (cols 1266, 1268, 1270, 1272). In none of the passages did she refer to the possibility that the Chief Ombudsman might decline to decide on their merits any of the complaints which came to his notice after receipt of the Penrose Report. Subsequently in a response to the Treasury Select Committee she insinuated that might be the case, commenting at the end of a long response to a question that “We have a system in place, and I make this in a completely independent context, in which, were there to be any systemic implications, then it is possible for that sort of process to move out of the hands of the Financial Ombudsman into the FSA. It is also possible that the Financial Ombudsman could say that these are not questions for him but ones that can only be taken up by the courts. That is the legal structure that is in place and it would be wholly inappropriate for me to make any comment.” But the significance of these comments was so opaque that none of the MPs picked it up; it seems more than likely that by this time the Financial Ombudsman had been squared up either directly by her or by a Treasury official or by the FSA.

26. The Penrose Report resulted in about 50 further complaints. The FSA’s first delaying tactic was to grant successive waivers to Equitable relieving it of its obligation to provide an answer to Penrose-related consumer complaints until the end of October 2004¹⁷.

¹⁷ That this is precisely what the FSA planned to achieve is made clear in its letter to Mr. LL dated 19 January 2006 cited in Lord Neil’s opinion:

“We have also granted similar waivers, for limited periods, to extend the time within which EL had to review general complaints and, more recently, ‘Penrose-related’ complaints, so that it could properly consider cases before policyholders were able to refer them to the ... (FOS).”

27. The FOS's next step in protecting Equitable was to circularise the 50 or so complainants in early to mid December asking for their reactions to Equitable's submission by 31 December, effectively allowing them a maximum of four weeks through the Christmas period to respond to a lengthy legal document that would have been very difficult for many of the complainants to address – this after Equitable's lawyers had had 6 months to prepare their submission.

28. Eventually, on 22 March 2005, the Chief Ombudsman published his decision that he was applying his discretion and would not consider Penrose-related complaints. His excuses included among others that:

- “It seems probable that the PIA Ombudsman would have dismissed equivalent complaints”

Comment – This was purely a speculation.

- “I am satisfied that there are court proceedings, disciplinary proceedings and other enquiries and investigations under way regarding some aspects of the subject matter of these complaints”

Comment – First, this provision is intended to apply to a situation where a complainant pursues court action over the same issue, which was not the case with the 50 complainants. Second, none of the other processes were related to the over-bonusing issue.

- “Even if no current court proceedings determine the subject matter conclusively, I am satisfied that it would be more suitable for these complaints to be dealt with by a court”

Comment – This statement is an abrogation of the FOS' rationale for its existence, which its website describes as “a free and informal alternative to going to court”.

- “The FSA's conclusions constitute a fact I cannot ignore. It clearly took both legal and actuarial advice. But it is irrelevant to me how it reached these conclusions”

Comment – This was an extraordinary assertion. Since he claimed he had not checked the details of the FSA's advice, he was in no position to rely on it.

- “The wide implications in any investigation that potentially affects up to a million people, contrasted with the relatively small number who have complained”. This appeared to refer to his assessment that “our intervention in this arena would add to rather than subtract from the turbulence affecting this aspect of the affairs of the Society and its members. In the particular circumstances of these cases, this reinforces my view that this matter is not an appropriate one for the Financial Ombudsman Service to consider”

Comment – The duty of the FOS is to resolve consumer complaints, not to prop up companies.

- “If we required Equitable Life to pay compensation to some policyholders, it would be taken from the with-profits fund and so would be to the disadvantage of other policyholders...In effect, any

award of compensation to those who had complained would have to be found out of the with profits fund that is the sole source of funds for Equitable Life members. Some major scheme of re-arrangement of fund values would be necessary”

Comment - Taking this argument to reductio ad absurdum would imply that FOS should not make awards against mutuals. In any case there is no reason to believe that awards to just 50 complainants would require a scheme of arrangement.

29. The Chief Ombudsman dismissed what many, if not all, people would regard as the clear promise by the government that the FOS would investigate the complaints with the claim that “the then Financial Secretary made no commitment that the Financial Ombudsman Service would, in fact, investigate these complaints. She was careful not to do so.” *This was a truly dissembling excuse.*

30. Lord Neill comments (116) “What does stand out is that Mr. Merricks [the Chief Ombudsman] appears to have been dominated by the FSA’s conclusion that the Penrose-related claims against EL are “unlikely to succeed” and that a decision favourable to the complainants would result in a stalemate. Documents recently obtained from the Treasury on 25 January 2007 under the Freedom of Information Act suggest that the dominance of the FSA’s view was not fortuitous. In particular an internal Treasury e-mail dated 18 June 2004 records:

“The FSA appear to have decided that they will not publish the reports prepared for them (a report by an independent actuary and counsel’s opinion). They propose in due course publishing some sort of statement setting out the overall conclusions of the work – *this will not happen until after they have discussed the content of any such statement with the FOS (the main purpose of the statement would be to provide FOS with a basis for considering complaints relating to overallocation). I understand that initial discussions with FOS will be held early next week*”. *(italics added).*

31. “Not only does Mr. Merricks quote the statement of the FSA about Penrose-related complaints against EL (Decision paragraph 12) he also makes reference to a further statement made by the Chairman of the FSA in a letter dated 7 July 2004 addressed to the Parliamentary Ombudsman. He leads into this in paragraph 34 of the Decision by saying that under the Memorandum of Understanding “we” (meaning thereby the FOS) “would refer the regulatory issues to the FSA. And I am confronted by the fact that the FSA has already investigated the very issues that are the subject matter of these complaints and has reached its conclusions”. With this introduction he launches into a quotation from the letter of 7 July 2004:

“We also think that there is real doubt about whether any loss can in fact be attributed to the regulatory system...”.

The Parliamentary Ombudsman concluded otherwise in several findings of maladministration with injustice.

32. Lord Neill concluded with a section headed “The answers to the Questions put to me” (177):

- (1) The impression gained by the complainants whose cases I have studied is that the FOS is not a body which holds the scales of justice evenly. It is a body which in many ways and in many instances has displayed partiality towards the financial firm, in this case EL.
- (2) The complainants did not expect to be treated with any special favour but they did believe that the FOS would be sensitive to the fact that the complainants had suffered serious financial loss and sensitive to the point that in nearly every case they were without any legal assistance.
- (3) The long delays in processing complaints had a corrosive effect. Complainants lost confidence in the system and began to feel that the FOS was stalling.
- (4) Many of the case studies reveal attitudes on the part of FOS officials which the complainants felt were unhelpful, unnecessarily argumentative, or even aggressive.
- (5) At worst the officials were seen as advocates for EL. In some instances, without any reference back to EL, they had come up with their own arguments to block the complainant.
- (6) There seems to have been a general feeling of outrage among complainants that Penrose-related complaints were not allowed to remain with the FOS for adjudication. Without knowing the legal niceties complainants as a whole thought that a Government Minister had in March 2004 pointed them firmly in the direction of the Chief Ombudsman. This was where complaints based on Lord Penrose were to be taken. Enormous disillusionment followed the Chief Ombudsman’s decision a year later that he would not consider any of these complaints. Public cynicism being rampant, there arose at once the belief that the FOS had been ‘leant upon’. The internal Treasury e-mail dated 18 June 2004 (disclosed to EMAG under the Freedom of Information Act on 25 January 2007 and quoted in Paragraph 116 above) shows, at its lowest, that the FSA was seeking to “provide FOS with a basis” for considering Penrose related complaints and that discussions to this end would take place between the FSA and the FOS in the week following 18 June 2004.
- (7) Those complainants who have succeeded through the FOS in establishing liability on the part of EL have been dismayed by the difficulties confronting them in ascertaining the amount of damages which they are entitled to claim. The attitude of detachment to this issue on the part of the FOS has led to repeated and strong protests by complainants. Many such protests are recorded here.
- (8) The general inefficiency of the FOS and the lack of concern with the special facts of individual cases (possibly fed by the ‘lead case’ method) have caused complainants to form the view that their interests have not been well looked after”.

33. Having dismissed “Penrose related complaints” one of the FOS’s specialists in fending off the more difficult complaints, Mr. John Todd, then asserted that all manner of complaints were “Penrose related”. This included my own complaint which related to Equitable’s failure during 2001 and 2002 to provide adequate information about the with-profits fund, which I would have used to exit the fund before I did. (My case is summarised pp94-101 of Lord Neill’s report).

34. In June 2007 Merricks was awarded a CBE for “services to *the financial services industry*”, (*italics added*) – surely a perverse reason for honouring an ombudsman whose website proclaims:-

“What all ombudsmen have in common is that they help the ordinary man or woman resolve disputes with organisations that might otherwise seem too big or powerful to take on single-handed”.

Game, set, and tournament to the FSA – policyholders lose.

KEEPING THE EQUITABLE’S FINANCIAL SITUATION FROM THE POLICYHOLDERS

35. A fundamental part of the FSA’s strategy was to maintain that Equitable was solvent – the media were assured that “Equitable remains solvent”. [14/12/2000].

36. At the suggestion of EMAG, the old board of Equitable commissioned Nicholas Warren QC and Thomas Lowe to advise on whether the House of Lords case could be reopened. He delivered his opinion on 8 May 2001 concluding that it was not feasible to go back to the House of Lords but suggesting that the non-GARs had claims against Equitable for mis-selling. They said that further work on mis-selling was required, and were commissioned to provide a further opinion on the issue. The new chairman of Equitable, Vanni Treves, and the chairman of the FSA, Howard Davies, discussed the opinion [09/05/2001]. The latter wondered whether it could be released in redacted form (i.e. censored as to the mis-selling part). Treves thought not, and it was published.

37. Equitable’s new management of chief executive Charles Thomson and appointed actuary Peter Nowell reviewed Equitable’s financial situation, and concluded that there would have to be significant cuts in policy values to try and bring policy values back in line with assets. Notwithstanding that policy values exceeded assets by 21% [11/07/2001] the cuts were only 16%. Although Nowell proposed the devaluation be by a percentage cut to non-guaranteed bonuses which would have borne most heavily on the longest standing policyholders (notably those with GARs) who had benefited

most from the overbonusing, the cut was made as an across the board reduction of 16%. This was manifestly unfair to policyholders who had joined Equitable more recently. *The FSA should have rejected the methodology as unfair.*

38. Despite repeated requests by EMAG¹⁸, the FSA refused to require that Equitable publish the Financial Review that underpinned the cuts and other information which policyholders of a mutual should by rights have had about the business which they owned.

39. On 20 July 2001 Equitable informed the FSA that on the previous day around lunchtime, when the FTSE stood at 5320, “it is likely the cover ratio was about 1.0” i.e. just covering the required minimum margin. In a letter of 20 July 2001 Equitable mentioned “...that when the markets fell to 5320 on 19 July, they thought that the surplus had just about been eliminated. Since then of course the FTSE 100 fell slightly further, hitting a low around 25 July of 5220”. *So even with the valueless reinsurance treaty valued at some £700m Equitable was below the required minimum margin.*

40. Counsel for Equitable had opined that mis-selling compensation could be in the range £1-1½ billion [05/07/2001]. “It was clear that Warren was not going to be dissuaded from saying that there had been mis-selling back to 1988 and 1989” [06/07/2001]. Concern was expressed as to whether Equitable was now solvent on a Companies Act basis [09/07/2001].

41. On 23 July 2001 Ian Glick QC and Richard Snowden, counsel for the FSA, delivered an opinion on mis-selling and the FSA noted a potential liability of £2-3 billion as being the amount of compensation due to the non-GAR policyholders. Later that day Warren provided his opinion that “The non-GARs are, in broad terms, entitled to be put in the position they would have been if there had been no GAR liabilities”, which would have essentially nullified the effect of the House of Lords decision. The FSA’s Head of Actuarial Support said:

‘If, for example, they are likely to incur mis-selling claims on all post-1993 policies, then the liability could be around £3-4 billion, which would be well beyond their current free reserves on a Companies Act basis of around £1½ billion. If the potential claims extend back to 1988 or even earlier, then the situation is clearly even worse.

Even if the Limitations Act applies (which seems very odd to me as a layman given that it was not the fault of the policyholders that they could only have been likely to have become aware of the alleged non-disclosure in 1998 or even later), then the liability could be around

¹⁸ Letter from John Tiner, Managing Director, FSA dated 10 January 2003 which responded to various letters from EMAG including one of 12 November 2002 titled “A complaint regarding the lack of information provided by the Equitable to its members”. Tiner refused to do anything to make Equitable provide information.

£2½ to £3½ billion, assuming that there would be a liability in respect of all premiums paid in the last 6 years. The result is still then likely to be insolvency’.

42. On 24/08/2001 Equitable’s Finance Director said that:

‘In short Warren was “becoming more aggressive on mis-selling”. He was tending to the view that all cases should be treated as advice cases; and that the full cost had to be borne by the GAR policyholders rather than the non-GARs, the effect of which was to require that mis-selling costs should be grossed up to take account of damage to future bonus prospects’.

43. The FSA’s counsel was essentially agreeing with Warren [25/07/2001], whose ‘draft opinion implied that [Equitable] was insolvent (and had been for some years)’.

44. On 25 July 2001 there was a meeting between the FSA, the Treasury and the Bank of England regarding whether there were arguments for an injection of public funds into Equitable. The note of the meeting records:

‘[FSA’s Chairman] said that something between £3 and £5bn would make [Equitable] solvent. [FSA’s Director of Insurance] said that it was difficult to assess what additional contribution to the pot might be necessary to make a s.425 scheme attractive to [Equitable] policyholders. But while the insurance industry would probably not be keen on a rescue, it might be readier to consider this if the government was involved. [FSA’s Chairman] said that if the government put money into the company, it would be interpreted as a problem with the past regulatory regime’.

So there you have the agenda.

45. On Thursday 26 July 2001 Davies met Kelly. A Treasury official advised her that administration was the best course and Equitable would possibly go into provisional liquidation or administration the following Monday.

46. On Saturday 28 July 2001 the FSA met with a firm of accountants “who Equitable were likely to appoint as Administrator or Liquidator if either of those routes were followed”. Later that day a Treasury Official noted that the Association of British Insurers “were clear that it was not the responsibility of their members to contribute to ‘a sweetener of a [compromise] scheme – the issue was to do with regulatory failure’”. On Sunday 29 July 2001 the FSA met with the Treasury at 11 am to prepare plans in view of Equitable’s board meeting at 3 pm that afternoon. Davies was to tell Treves that they felt it “would be unwise to publish the Warren opinion without greater clarity about the Society’s financial position”. The FSA met with counsel who “had revised his opinion and that he

was now saying that mis-selling liabilities should not exceed the impact on policy values caused by the existence of GARs” [which appears to imply a value of £1.5bn, the sum Equitable assessed before the Compromise as being the transfer from non-GARs to GARs]. At 6 pm that evening the FSA met Equitable to be told that Equitable was solvent. No figures were provided to support this, other than that the mis-selling liability was put in at a figure of £900 million. Later that same evening the Treasury prepared a briefing for a meeting with Brown the following morning Monday 30 July 2001, see para 6.

47. There was further discussion about publication of Warren’s opinion at a meeting of the Tripartite Standing Committee on 31 July 2001. It was agreed that “it would be helpful if publication of the Opinion could be delayed until more work could be carried out. The FSA could have power to prevent Equitable from publishing the Opinion, although they would need to consult Ministers on its use”. (Subsequently the FSA sent the Treasury a draft order to prevent the publication of Warren’s opinion [10/08/2001]). The FSA told the Committee that:

‘... the Equitable Board had convinced both themselves and the FSA that they could go on making payments and were not insolvent and the FSA had no basis for challenging that...The cost on a Warren market average comparator basis, was apparently not as great as originally feared. The £3.0 - 5.0 billion first estimate had been very much a cockshy.’

48. On 24 August the FSA met a firm of actuaries who had been asked to review Equitable’s solvency, and were told that Equitable was solvent - *but no account was being taken of the mis-selling liabilities until the legal position was clarified and an allowance of £664 million was made for the valueless reinsurance treaty.*

49. On 2 August 2001 FSA’s Head of Actuarial Support’s calculation concluded:

‘...It does though seem that a “rational worst case” scenario could result in a provision of around £1.5-2.5 billion, though we could not rule out the possibility of the Courts taking an even worse interpretation (e.g. on assumption (4) above which could add another £500m-£1Bn, or on assumption (10) which could add a further £1 billion)’. He comments that these are ‘very tentative figures’.

THE FSA STITCH UP NON-GAR POLICYHOLDERS WITH THE COMPROMISE SETTLEMENT

Planning for the Compromise – discounting Warren’s opinion

50. On 7 August 2001 FSA's Managing Director A had 'a good deal of discomfort' about Equitable's proposed policyholder communication and observed '...The Society therefore potentially continues after a compromise with less uncertainty about the future but with very little initial room for manoeuvre. (For example a 10% fall in share prices just after the compromise would spark another round of policy value reductions - and such risks need to be spelled out)'. (*They never were*).

51. Also that day Equitable advised FSA 'They are of the view that the compensation cost is additional, and therefore a charge on the with-profits fund as a whole (and ranks ahead of any "liability" to pay discretionary benefits.) As it is a charge against the fund as a whole, this means it has effectively to be met by all policyholders, *and therefore is paid for substantially by the non-GARs*' (*italics added*). The FSA buy in to this proposition. The following day Chief Counsel B advises that FSA's shared legal view is that any mis-selling compensation is a charge to be borne by all with-profits policyholders 'with the result that Non Gars as a class bear a substantial part of the mis-selling costs'. This concept was sophistical. Consider *reductio ad absurdum*. The first person who was sold a non-GAR policy by Equitable without declaring the prior interest of the GARs arising from the unfunded GAR. It is absurd to suggest that if the policy were mis-sold to him the claimant should effectively pay part of the compensation himself. Again take the case of somebody joining Equitable after the House of Lords case without being told about the prior interest of the GARs - why should (s)he immediately suffer a 75% reduction in any compensation? *Compensation for mis-selling to non-GARs should either have come from the government for regulatory failure or, as Warren argued from the GARs, or both.*

52. At the end of August legal staff in the FSA are concerned that the non-GARs would get a worse deal under the Compromise by giving up their mis-selling rights rather than retaining those rights and taking action either through the FOS or the courts. On 30 August 2001 the FSA's Director of the General Counsel Division (GCD) wrote that he:

'... [thinks the Director of Insurance] is looking for advice on the substance of the proposal that we would limit the amount we would mandate to what effectively- people would get under the 425 scheme...would we be criticised as subordinating interests of mis-selling victims to desire to see 425 scheme agreed...'

Legal Adviser F said that he agreed: 'but our comments immediately re-raise a major concern I have about the 425 scheme (hopefully a presentational one). If the scheme is massively out of kilter (lower)

with what the court/ombudsman would award (on our best guess/advice etc) then how can FSA possibly stand by and be seen to endorse it as fair? If it is fair under the 425 scheme, then why would FSA be under attack for the matters you mention? The Director of Insurance replied to the Director of GCD “as to policy reasons underlying the approach to discounting it is partly as [the Director of GCD] suggests. But as we discussed I think it is as, if not more, important that we recognise that “grossing up” (to put it the other way) could produce a level of claims by individuals which, if granted to all, would damage the fund, perhaps ultimately to the point of insolvency...’.

53. Also on 30 August 2001 the Director of Insurance states that the FSA’s policy objectives include “a) I think that policyholders do need to know the probable consequences of not approving the scheme, whether good or bad. This is the approach we have insisted the Society take in presenting the scheme - hence the detail on winding up etc in the documentation. It is also consistent with the criteria we are applying to our attitude to the scheme that in its component parts and across the piece that it should represent a fair exchange between what policyholders are gaining and what they are giving up, and that this should be clearly explained. In giving up mis-selling rights policyholders are giving up whatever review/redress scheme might give them, and they need to understand what this might involve and what it might mean for them”. *And so say all of us.*

54. As noted in para 21, on 30 August the PIA commented that “To head this one off we would have to get the FOS to sign up to our position (which I would have thought they could do without compromising their freedom to look at each case individually). *That would leave the courts as the only alternative avenue still open*” (*italics added*).

55. On 20 September 2001 Equitable published “Proposed Compromise: Ready for your comments”. Equitable stated the liability for claims from non-GARs as follows:-

“The theoretical aggregate sum of all the potential claims of non-GAR policyholders has been estimated to be £850 million. However, not all these claims are likely to be successful. The range of probability of success of these potential claims, when taken as a whole, was estimated by the Society’s legal advisers to vary widely from perhaps 20% to 70%.

Around 75% by value of the Society’s with-profits fund is made up of non-GAR policies. Any successful claims would have to be met out of the with-profits fund largely owned by non-GAR policyholders. Therefore, around 75% of non-GAR policyholders’ claims could end up being paid for by non-GAR policyholders themselves. As a result compensation would have to be reduced by 75%. There are differing legal views on whether, if a claim was framed in a

certain way, this would still be the case. The range of discount on account of this would therefore be up to 75% depending on which legal opinions were followed. The lawyers, however, all agree that there is doubt and that the contrary view is arguable. There is insufficient time to bring a test case, and probable appeals from it, to resolve the issue if the compromise is to be in place before 1 March 2002 which is the deadline for receipt of the Halifax £250 million.

In summary, the total estimated value of potential claims of £850 million needs to be discounted with regard to the probability of success (between 20% and 70%) and with regard to non-GAR policyholders paying for non-GAR claims themselves (between 0% and 75% but estimated to be between 25% and 65%). Having carefully examined the range of legal advice the new Board has taken the view that the likely value for potential claims lies in the range of £100 million to £300 million and has decided to propose a scheme using a value of £220 million”.

56. On the same day the FSA published a serious opinion on mis-selling, and Equitable published an opinion; in response to Warren’s 139 page opinion it was a 12 page featherweight opinion.

FSA’s concerns about financial viability/solvency of Equitable

57. Equitable’s Appointed Actuary faxed a letter to FSA’s Head of Actuarial Support informing of the existence of a side letter to the reinsurance treaty [24/09/2001]. The letter said it was never intended to claim more than £100 million on the reinsurance treaty. On 25 September 2001 the Head of Actuarial Support commented:

‘We have a further problem that has emerged. Apparently, Chris Headdon signed a side letter on behalf of Equitable which was not disclosed to us, but calls into serious question the validity of the reinsurance offset of £700 million for which they are taking credit. This would of course mean that they are now well below their required margin of solvency’.

Also that day he observed “that the policy value information would be likely to show policy values 8-10% higher than underlying assets” (italics added).

58. The Head of Actuarial Support commented [27/09/2001] ‘I would be doubtful about allowing even a value of £100 million in view of the intent expressed that they would never wish to make any “cash” claim on the reinsurer...Nevertheless, the balance sheet that they included in their presentation allowed for a value of £674 million to be ascribed to this reinsurance agreement...’ [28/09/2001].

59. On 2 October 2001 the Director of Insurance also raises an issue of separate concern that payouts on maturity may still be more than asset share. He noted that Equitable “naturally, are not

keen to announce a further reduction in policy values at this point since they judge that this would damage, probably fatally, their change of gaining agreement to the Compromise”. The Head of Actuarial Support circulated his estimate of mis-selling liabilities dated 1 October 2001. He said it was likely that Equitable were still solvent and may just be covering their required margin of solvency *‘but there remains fundamental uncertainty relating to the amount of these misselling claims’*. On current payouts he says:

‘... I would estimate that the claim values paid on contractual events are around 5-7% too high. At present, the free reserves in the balance sheet seem to be falling by around £200 million every month, mainly as a result I believe of the payment of final bonuses on claims for which there is no provision on the balance sheet.’

60. On 8 October 2001 FSA’s Director of Insurance said “I guess the court may also be interested in establishing a view on solvency where I guess we are still in the “fundamental uncertainty” position”. Later the Head of Life Insurance suggested that the FSA think seriously about removing the relevant page from their website as an interim measure until the position has been clarified (noting ‘This can be explained as being for updating’). He also suggests reviewing the line taken in response to press queries. Also that day “Equitable state that policy values were not significantly out of line, reporting to FSA that: *‘At the stock market lows, aggregate values stood at about 105% of the value of the with-profits fund, but they were now back to around 102%’*”. On 7 November 2001 Equitable send a calculation of policy values compared with assets showing a ratio of 101.0%. The FSA should, however, have known that these figures were derived from the Office Valuation and overstated the effect of the 16% cut in policy values in July because for the most part policies could not be cut below their guaranteed value and recent policies would not have built up a non-guaranteed bonus of 16%. An estimate by accountants Burgess Hodgson is that the correct figure was a deficit of the order of 4.5%. *This left less than nothing whatsoever in the fund to pay for the offer of a 2.5% largely non-guaranteed uplift to non-GARS. And in due course they received less than nothing, see para 72.*

61. On 6 November ‘...[FSA’s Director of Insurance] said we had a particular concern that to ensure that policyholders would not be asked to vote on the scheme on the basis of misleading information about the value of the company’. *As usual the FSA did nothing to effect its concern.*

62. On 12 November 2001 FSA's Scrutinising Actuary F concludes that his 'overall reaction is that this arrangement [viz, the reinsurance treaty] is little more than 'window dressing' and that the reinsurer has no intention of assuming any serious risk at all'.

63. On 14 November 2001 the Head of Life Insurance briefs the Chairman of the FSA on the Compromise scheme, and among other things stated:

'We discussed with Equitable whether a balance sheet as at 30 September could be produced. However, their view is that the Directors have an obligation to verify any information included in the Scheme documents, and they would want the auditors to review it. This could not be done in the time available before the launch of the Scheme. This issue remains under discussion. We have been particularly concerned that the policy values quoted to policyholders in connection with the Scheme should not give a misleading impression (for example, if aggregate policy values were significantly higher than asset shares, there must be a serious prospect of a future cut in policy values (by way of a reduction in final bonus); and policyholders would need to understand this when they voted on the Scheme).'

But of course the FSA did nothing to effect its concerns.

64. Late November there was a farcical "think of a number game" in the FSA regarding the value to be put on the reinsurance treaty. On 20 November 2001 the FSA was considering allowing up £600 million; two days later £380 million at 7 pm, then £350 million later that evening. Even as the Compromise documentation was being printed [28/11/2001]:-

"FSA's Scrutinising Actuary F sends the Head of Actuarial Support a spreadsheet which tracks how the reinsurance treaty might operate in practice. He says: "The value of the treaty to Equitable would be represented by the entries in the final column. However, as these figures decrease to zero over years 15-30, I wonder whether any value can be ascribed to the treaty in the first place".

65. The Parliamentary Ombudsman concluded "I consider that the failure by the FSA, acting on behalf of the prudential regulators, (i) to ensure that the financial reinsurance arrangement was not taken into account within the Society's 1998 returns without an appropriate concession being given, and (ii) to ensure that the credit taken by the Society within its returns for 1998, 1999, and 2000 properly reflected the economic substance of that arrangement, constitutes maladministration".

The Compromise

66. The FSA wondered whether Equitable should publish financial information as at 30 September 2001 instead of 30 June 2001 for the Compromise. The 30 June accounts had no provision for mis-selling nor any mention of the problems with the reinsurance treaty. On 25 October 2001 the Head of Actuarial Support says that he believes that, on the basis of Equitable's letter, there remained a number of fundamental uncertainties about Equitable's position. Those were "a) I am not convinced on the basis of the information presented that it would be prudent to assume that credit can be taken for more than £100 million of reinsurance cover". *But of course the FSA did nothing.*

67. On 15 November FSA's Head of Actuarial Support set out his estimate of Equitable's solvency, which showed a deficit in free reserves at 31/10/2001 of £170m, which included an allowance of £100m for the valueless reinsurance contract, i.e. in reality the deficit was £270m. Also some of the other figures were regarded as dubious.

68. On 27 November 2001 John Tiner, the Chief Executive of the FSA, wrote to the then chairman of EMAG that "We agree that it is important for policyholders of the Society to have access to information about its financial condition before they are asked to vote on the Compromise. The FSA will be looking to ensure that the Society does all it reasonably can to provide that information". *Words come cheap from the FSA.*

69. On 4 December Equitable published the final Scheme Circular for the Compromise. Policyholders with GARs were to have an uplift of 17.5% to their *guaranteed* fund, while policyholders without GARs were to have a 2½% uplift to their *non-guaranteed* fund (of this just 0.4% was eventually given as guaranteed). All policyholders who were in Equitable at the date of the compromise were to lose any legal right to claim for mis-selling, a provision which had greatest impact on the non-GARs.

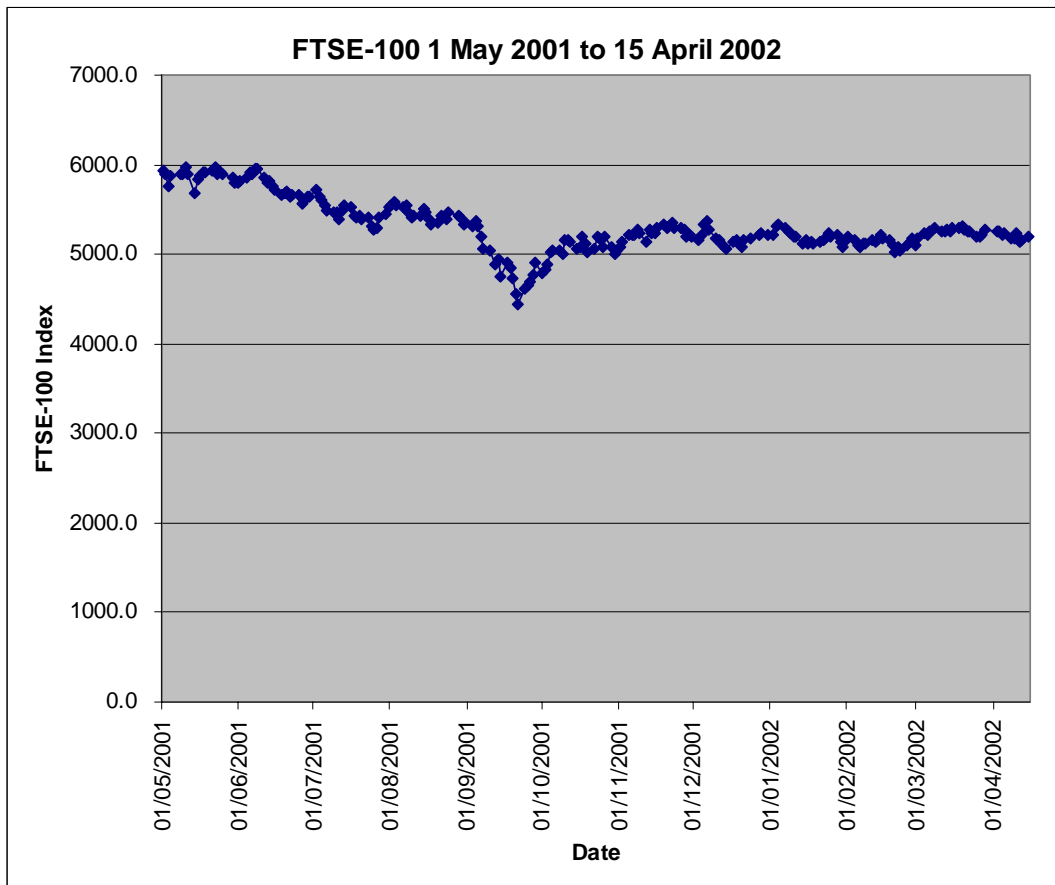
70. "The FSA's Assessment of Equitable Life's Compromise Scheme" was put on its website on 7/12/2001. Among other things:-

- "The FSA also stated that it believed it was important that the Compromise put to policyholders should be clear and should provide them with information they need to form their own judgment about how to vote on the proposals put to them" (para 9)
- "...we think that the Compromise is a reasonable way to address non-GAR policyholders' potential mis-selling claims"(para 30)

- “The FSA is content that, in relation to the relevant groups of guaranteed annuity rate (“GAR”) and non-GAR policyholders, the level of the increase to policy values is a fair offer for the GAR rights and potential mis-selling claims that would be given up” (para 3)

71. On 12 January 2002 the members of Equitable voted on the Compromise with 98% in favour and on 4 February the court approved the Compromise. The FSA made no representation to the court about Equitable’s true financial situation.

72. On 15 April 2002, although the stock market was at the same level that it had been in November 2001 when the Compromise was finalized (see exhibit), Equitable cut policy values by 4%; on 1 July 2002 Equitable cut policy values by a further 6%.



73. Although the conduct of the Compromise unfortunately falls outside the PO’s jurisdiction she commented of the post closure period which includes virtually all of the time up to publication of the Compromise scheme **“that the misleading information, about the Society’s solvency position and its record of compliance with other regulatory requirements, that was produced by the FSA,**

acting on behalf of the prudential regulators, during the period after the Society closed to new business, constitutes maladministration”. Did the FSA knowingly condone a Compromise that was based on a pledge to non-GAR policyholders that could not be honoured?

Game, set and Wimbledon to the Treasury and FSA.

THE FAILED ATTEMPT BY THE FSA TO DEAL WITH POLICYHOLDERS WHO HAD LEFT

74. On 20 August 2001 FSA’s Head of Life Insurance writes that ‘Equitable needed to have a plan to deal with policyholders who had left before the Compromise was effective, but who retained potential mis-selling claims’. On 30 September 2002, with the backing of the FSA, Equitable proposed another S425 settlement with an offer of compensation of up to 5% of policy value¹⁹ to 70,000 former policyholders who had left to retain their right to claim for mis-selling. This offer was less than the policyholders had lost through paying a market value adjuster to leave the fund, let alone the 16% cut in pension policy values in July 2001, and would have eliminated their right to seek legal redress against Equitable. The Equitable Late Joiners Action Group (ELJAG) raised a substantial legal fighting fund to obtain restitution of the losses they had incurred. ELJAG had an opinion from George Bompas QC dated 9 April 2003 which stated that “in my opinion ELJAG have a prima facie cause of action in deceit [i.e. fraud]...claims of ELJAG’s members are formidable”.

75. ELJAG and solicitors met representatives of the FSA in December 2002 after a new proposed S425 scheme had been announced. At that time Equitable was presenting the scheme as approved by the FSA and was expected imminently to send details of it to the departed late joiners. The FSA had a copy of a letter that ELJAG’s solicitors had sent to Equitable setting out in detail ELJAG’s claim for fraud. ELJAG made clear to the FSA that if Equitable persisted with the proposed scheme it would oppose it in court, and undertake a discovery process of specified board minutes and other documents which would doubtless have caused Equitable and the FSA at least great embarrassment, if not worse. Following this meeting, there was no further communication about the proposed scheme and it was dropped.

¹⁹ This flawed figure was derived by Deloitte making a comparison with how other with-profits policies in other companies had fared and assuming that the alternative to investing in Equitable and suffering its MVA on leaving was to invest in another life assurer and *also suffer its MVA*. There is, however, no reason to believe that if an investor had invested elsewhere (s)he would have withdrawn the policy and suffered an MVA. The opinion also put a speculative value of "up to 6.5%" on the greater flexibility of Equitable's policies and opined that flexibility was an important selling point that "may" have been an important attraction. This approach to selecting 6.5% - why not 3.5%? why not 9.5%? – was regrettably too typical of the way numbers were bandied around in this sorry tale to protect Equitable at the expense of policyholders who knew no better.

76. ELJAG are believed to have reached an entirely satisfactory (but gagged) outcome to their claim for rescission. The press reported a settlement of £5m. Equitable settled out of court with others who pressed their case with heavy legal firepower and ignored Lovells' threats. In all cases the settlements were accompanied by confidentiality agreements. Those who had the money and were prepared to take legal action and withstand threats of heavy legal costs if they lost won reasonable compensation.

77. *The little people lost thanks to the FSA and FOS.*

* * *

78. Most of the dramatis personae in this shabby tale have moved on, either to civil service cost indexed pensions courtesy of the taxpayer, or to other roles which are either comfortable or profitable. The FSA subsequently failed the regulation of Northern Rock for several of the same reasons that it failed the regulation of Equitable. Various professionals have feasted on Equitable policyholders; the abortive legal case that Equitable ran against the former directors alone cost policyholders £45m in professional fees. As is customary in British financial scandals, the little guys get stuffed.

Alex Henney
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