

# EUROPEAN PARLIAMENT

2004



2009

*Committee on Petitions*

25.01.2007

## NOTICE TO MEMBERS

**Petition 0303/2006 by Mr. Graham Senior Milne (British), on the Financial Services Authority (FSA) for failure to insure the protection of policyholders in the case of Scottish Widows demutualization**

### 1. Summary of petition

The petitioner, a Chartered Accountant, claims that the Financial Services Authority (FSA) failed to take the necessary steps in order to prevent serious financial losses for Scottish Widows' policyholders following its taking over by Lloyds TSB in 2000. The petitioner maintains that FSA didn't ensure that policyholders were properly informed, in accordance with the EU legislation. He considers that FSA acted as a "dishonest broker" in the Scottish Widows' demutualization process and asks the European Parliament to set up a Committee of Enquiry into this case similar to the one on Equitable Life.

### 2. Admissibility

Declared admissible on 18 September 2006. Information requested from the Commission under Rule 192(4).

### 3. Commission reply, received on 25 January 2007.

Background/summary of the facts

**Scottish Widows (SW)** was a UK mutual insurance undertaking, which did not have shareholders but was owned by its members/policyholders. It abandoned its mutual status ("demutualised") in March 2000, and was acquired by the **Lloyds TSB Group (LTSB)**. As is customary in the case of demutualisations, the purchase price paid by LTSB was distributed among the SW members/policyholders. The purchase price was £6 billion, of which £4.5 billion was paid out, while £1.5 billion was retained in an "Additional Account". This additional account was set up in order to meet contingencies. The Policyholder Circular issued in November 1999 stated that these contingencies included "the costs of meeting guarantees on policies allocated to the With Profits Fund, including the cost of guaranteed

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annuity options". LTSB issued an announcement on 31 January 2002 concerning the use of this additional account. It stated that "at the time of the demutualisation of Scottish Widows in March 2000, and its acquisition by Lloyds TSB Group, the guaranteed annuities case (*Equitable Life v Hyman*) was already in progress. As a contingency for a possible change to the way in which the financial services industry pays guaranteed annuity rate policies, an Additional Account, including interest rate hedges, was set up by Scottish Widows to allow for such a contingency and to protect both policyholders and shareholders". LTSB said that it had revised its practice following the decision in the **Equitable Life (EL)** case and that "as a result of the change, final or 'terminal' bonuses for most guaranteed annuity rate policies will be increased. The Additional Account will be used to meet the cost of enhancing pensions for those guaranteed policies".

Policies giving the option to take out an annuity at a **guaranteed annuity rate (GAR)** were issued in large numbers by many UK life assurance undertakings over a number of years. In a period of high inflation and high interest rates, the GAR option was not a problem for the issuing undertakings. As interest rates fell, the GAR option became "in the money" and was increasingly valuable. Issuing undertakings were thus locked into paying out high annuity rates that were increasingly hard to finance.

The GAR problem is one of the main reasons for the virtual collapse of the Equitable Life Assurance Society (EL), which is currently the subject of a European Parliament Committee of Enquiry.

EL had not reserved for an increasing uptake of the GAR option and believed it was entitled to mitigate the cost by adjusting downwards the terminal bonus paid to policyholders choosing to exercise the GAR option. This practice was challenged and this led EL to initiate a court action in 1999 (the *Hyman* case) to establish the legality or otherwise of its practice in respect of policyholders exercising the GAR option. When EL finally lost the case and was thus obliged to meet the cost of GAR policies in full, it was forced by the resulting financial crisis to put itself up for sale (unsuccessfully) and subsequently to close to new business.

### The Complaint

The Petitioner worked as an IT auditor for LTSB and was transferred to a similar job with SW in January 2002. He was not himself a SW policyholder but looked after the financial affairs of his mother, who was a policyholder. He states that she received a payment of around £4 000 as a result of the demutualisation.

Mr Senior-Milne states that he did not understand why the £1.5 billion had been held back and maintains that there was no meaningful explanation in the documentation sent to policyholders. His understanding was that this amount would be distributed to policyholders in some way after the demutualisation.

It was when LTSB issued its above-mentioned announcement on 31 January 2002 (soon after the Petitioner had transferred to SW) that he came to the conclusion that the £1.5 billion had been specifically set aside to meet the GAR liability and that the directors of LTSB and SW had misled both the policyholders and the Scottish court which had approved the demutualisation scheme. He thus believes that the policyholders had had a reasonable

expectation that they would ultimately recover the £1.5 billion, had approved the demutualisation on this basis and had in effect been defrauded of this amount. Mr Senior-Milne further maintains that the UK **Financial Services Authority (FSA)** failed in its duty to protect policyholders' interests in this case since it knew of the existence of the GAR liability of £1.5 billion but failed to ensure that SW disclosed this liability properly to policyholders on demutualisation. For the Petitioner, this specific failure on the part of the FSA forms part of its much larger failure in respect of the whole GAR issue across the UK life assurance industry.

Mr Senior-Milne brought his concerns to the attention of his management, then to his professional body and to the external auditors. He was dismissed, in his view because of his whistle-blowing activities, and has been fighting ever since to obtain justice, at great cost to his health and personal life.

#### The Commission's comments on the Petitioner's arguments

A large part of the Petition document relates to the harassment of which the Petitioner believes he has been a victim as a result of his whistle-blowing and to the failure of numerous bodies and authorities to respond to his complaints.

The Commission cannot validly comment on matters such as Mr Senior-Milne's dismissal or the harassment of which he has been a victim. Matters such as these can only be examined and resolved in the national context, under national procedures and before national authorities or courts. The Commission has no competence in such matters and does not believe that issues of Community law are involved.

As regards the insurance aspects of this Petition, the Commission has stated in the EL context that it was not aware of any infringements of the relevant life assurance directives in the UK. The directives deal inter alia with the mathematical provisions which life assurance undertakings must hold in order to be able to meet their liabilities. It is stipulated, for example, that such provisions must be held to meet all guaranteed liabilities.

The Commission has reported at some length to the EP Committee of Enquiry into EL on how it checked the UK implementation of the life assurance directives.

The conduct of the UK authorities, including the FSA, in the matter of the supervision of EL (including the matter of policies with a GAR option) is currently the subject of investigations both by the EP Committee of Enquiry and the UK Parliamentary Ombudsman. The terms of reference of the former include an investigation into alleged contraventions or maladministration in the application of the Third Life Assurance Directive by the UK and an assessment of the UK regulatory regime in respect of EL. As regards the latter, the terms of reference of the current work of the Ombudsman are "to determine whether individuals were caused an injustice through maladministration in the period prior to December 2001 on the part of the public bodies responsible for the prudential regulation of the Equitable Life Assurance Society and/or the Government Actuary's Department; and to recommend appropriate redress for any injustice so caused".

The question of the UK supervisors' handling of the GAR issue is dealt with in great detail in

the Report of Lord Penrose on the EL Inquiry. The UK authorities responsible for insurance supervision (including the FSA as from 1 January 1999) certainly became well aware of the GAR issue. They were also aware of the practice of reducing the terminal bonus for those policyholders who took advantage of the GAR option. Expert opinion differed as to whether this was legitimate and it was this doubt that finally led EL to put the matter before the courts for a decision. The course of these legal proceedings, with EL winning in the High Court, losing on appeal (though with some hint of a feasible solution) and losing definitively before the House of Lords, shows that the issue was a highly complex one, the outcome of which was impossible to foresee in advance.

As LTSB stated in its 31 January 2002 announcement, the EL court action was already in progress at the time of the demutualisation of SW in March 2000 and its acquisition by LTSB. No-one knew at that time what the final result of the GAR court action would be (the House of Lords gave its ruling on 20 July 2000).

It was because of this uncertainty that LTSB set aside the Additional Account to meet contingencies. The Demutualisation Circular of 19 November 1999, published several months before the final EL ruling explained that: "the contingencies allocated to the With Profits Fund are any additional costs of meeting guaranteed benefits on transferred policies allocated to the With Profits Fund and any unexpected liabilities which arise in the future but relate (with certain exceptions) to the operation of the Society and its subsidiaries prior to the Effective Date.....".

The FSA seems to consider that this wording "generally made clear" to policyholders the existence of a potential GAR liability, while the Petitioner believes this indication to be a totally insufficient warning of a potential liability of £1.5 billion.

LTSB, like the managers of EL, no doubt hoped that the ruling of the courts in the matter of GAR policies would be more favourable and allow the insurers greater flexibility in dealing with the GAR problem. This presumably explains why LTSB did not choose to quantify and set out in its Circular the maximum possible liability.

No-one can say whether a clearer exposition of the maximum potential liability would have influenced SW policyholders in their decision on the demutualisation. It should be noted, however, that the GAR liability was a contingent liability on the with profits fund whether the insurer demutualised or not. Even if SW had remained a mutual it would still ultimately have had to face the consequences of the House of Lords decision in the EL affair, with the cost being met from the with profits fund.

SW policyholders received a payment when SW demutualised and was taken over. They probably hoped and believed that they would eventually benefit from a share of the £1.5 billion Additional Account. In the event, and following the final decision in the EL case, this amount was denied to the majority of policyholders and was used to meet the liability towards the GAR policyholders.

It could be argued that LTSB was prudent in setting aside a sufficient amount to meet the worst-case scenario in the GAR court action.

EL, for its part, did not have sufficient reserves to meet its corresponding liability and nearly collapsed as a result, being finally forced to close to new business.

## Conclusions

The Commission Services believe that it was prudent of LTSB to set aside an adequate reserve to meet the possible cost of an adverse decision in the EL court action. At the time of the demutualisation and the acquisition, SW and LTSB had no way of knowing what the final decision of the courts would be. It is a matter of judgement as to whether the information given concerning the contingent liability in the Demutualisation Circular was sufficient. The FSA concluded that it was. Whether the UK regulators and supervisors (including the FSA) acted properly and adequately protected policyholders' interests and expectations in the matter of the treatment of the GAR option will be dealt with in the conclusions of the European Parliament Committee of Enquiry into Equitable Life and the second report of the UK Parliamentary Ombudsman.