INVESTIGATION INTO THE PRUDENTIAL REGULATION OF EQUITABLE LIFE: A MEMORANDUM TO THE PETITIONS COMMITTEE OF THE EUROPEAN PARLIAMENT BY THE OFFICE OF THE PARLIAMENTARY OMBUDSMAN OF THE UNITED KINGDOM

September 2005

Introduction

1. This memorandum provides information about the role, powers, duties and responsibilities of the United Kingdom Parliamentary Commissioner for Administration (normally known as the Parliamentary Ombudsman) and sets out the scope of her current investigation into the prudential regulation of the Equitable Life Assurance Society against the context of the relevant statutory framework for the regulation of insurance companies.

2. It is submitted at the request of the Petitions Committee of the European Parliament in order to assist it to consider two petitions – both related to injustice claimed by current and former investors with Equitable Life as a result of the alleged incompatibility of domestic and European legislation – at a hearing on 13 September 2005.

The Parliamentary Ombudsman

3. The Parliamentary Ombudsman's role, powers, duties and responsibilities are set out in the Parliamentary Commissioner Act 1967, as subsequently amended. The current Ombudsman is Ann Abraham, who also holds the post of Health Service Ombudsman for England. The Ombudsman is independent of Government and she is not a civil servant.

4. Her role is to consider complaints (referred to her by a Member of the House of Commons) from individuals who claim to have suffered an unremedied injustice as a result of maladministration on the part of bodies within her jurisdiction in the discharge of their administrative functions.

5. The 1967 Act prescribes which public bodies are within the Ombudsman's jurisdiction - these are listed in Schedule 2 and in Schedule 4 to the Act. The Act also places restrictions on the types of complaint that the Ombudsman can investigate - Schedule 3 to the Act lists the types of administrative actions about which the Ombudsman may not conduct an investigation.

6. The above provisions mean that the Ombudsman has no power to consider complaints about the actions of bodies not listed as being within her jurisdiction; nor can she investigate actions of a nature prescribed by Schedule 3 to the Act or those taken in the discharge either of the judicial or the legislative functions of those bodies within her jurisdiction.

7. The Ombudsman cannot therefore examine complaints about the adequacy or fairness of legislation – whether domestic or European – and she may also not question the

merits of discretionary decisions - such as policy decisions taken by Government bodies - unless such decisions were taken with maladministration.

8. For the Ombudsman to be able in law to investigate any complaint, such a complaint therefore:

   (i) must concern a body in the Ombudsman's jurisdiction; *and*

   (ii) must relate to the administrative functions of such a body; *and*

   (iii) must involve action (or inaction) in the discharge of such a function that is of a type not excluded from the Ombudsman's jurisdiction by the 1967 Act.

9. The Ombudsman has extensive powers in relation to the production and scrutiny of evidence. She must provide a written report of the results of each investigation to the Member of Parliament who referred the complaint and also to the principal officer of the body whose actions were subject to investigation.

10. Where investigations relate to systemic issues or where otherwise she considers this to be in the public interest, the Ombudsman may lay her reports before both Houses of Parliament. However, her investigations must be conducted in private and the Ombudsman is not empowered to disclose information obtained in the course of any investigation other than through her final report or for related purposes.

11. Where the Ombudsman finds that maladministration has caused - or has contributed to - an unremedied injustice, she will make recommendations to remedy such an injustice. However, the Ombudsman has no power to compel a body in her jurisdiction to accept any of her recommendations and she cannot insist that a Government body provide a remedy for any injustice – such as financial loss - that she finds has been caused to an individual by maladministration. That said, her recommendations are normally accepted and a suitable remedy provided. Where this does not happen, the Ombudsman may bring this to Parliament's attention by means of a special report.

12. Where the Ombudsman receives many complaints about the same matters, it is her practice to conduct one representative investigation covering the situation of all those affected by the administrative actions in question.

Background to insurance regulation in the UK

13. The regulation of insurance companies within the United Kingdom since 1988 has been subject to two statutory regimes. During the first period, from April 1988 to December 2001, the regulatory regime was effectively split along functional lines and was based on two separate statutes: the Insurance Companies Act 1982, which concerned the prudential regulation of insurance undertakings, and the Financial Services Act 1986, which concerned the regulation of the conduct of business by - and the marketing activities of - such undertakings.

14. Responsibility for the prudential regulation of insurance companies – which was primarily related to oversight of the solvency of companies and ensuring that they were able to meet their liabilities to policyholders - lay with central Government

Departments - from 1988 to the end of 1997, the regulator was the Department of Trade and Industry; from early 1998 to December 2001, the regulator was Her Majesty's Treasury.

15. Advice to the regulator was provided by its lawyers and also by the Government Actuary's Department. Furthermore, from January 1999 aspects of the day-to-day supervision of insurance companies were contracted out to the Financial Services Authority, which in this role acted on behalf of Her Majesty's Treasury.

16. Conduct of business regulation during the whole first period was delegated to a system of industry and practitioner-based, self-regulatory organisations under the supervision of a designated agency, the Securities and Investments Board.

17. This regime was replaced on 1 December 2001 by the current integrated regulatory regime, governed by the Financial Services and Markets Act 2000, which, in this second period, combines all aspects of insurance regulation within the remit of one regulator – the Financial Services Authority, which now regulates the insurance industry in its own right.

The background to the Ombudsman's current investigation

18. The Ombudsman has received more than 750 referrals of complaints from individuals who claim to have suffered injustice as a result of alleged administrative failure by those responsible for regulating Equitable Life.

19. Her current investigation was initiated following a consultation exercise conducted by the Ombudsman following the publication of the report of the Penrose Inquiry in March 2004. Representations from investors and from the company itself supported such an investigation by an overwhelming majority; those from both the past and current regulators did not, for reasons given in the annexes to the Ombudsman's report to Parliament, in which she set out her decision to conduct a further investigation (see annex A to this memorandum).

Limits to the current investigation

20. The terms of reference for the investigation are set out in annex B to this memorandum.

21. While the scope of the investigation is far-reaching in time and covers many matters, there are a number of aspects of the relevant statutory provisions which place significant restrictions on what the investigation can determine.

22. The principal restrictions are as follows:

    (i) First, the Ombudsman cannot consider complaints related to whether the statutory framework in place at the relevant time was appropriate or sufficient – nor is it her role to determine whether domestic legislation was compatible with European legislation.

As explained above, the Ombudsman may only investigate certain administrative actions of bodies in her remit. The investigation will have regard to the regulatory regime in place at the relevant time. However, in conducting the investigation, the Ombudsman's role will be to determine whether the relevant domestic regulatory regime was properly administered and not whether it was properly conceived and created or whether it meets (or met) the requirements of European law.

The Ombudsman's investigation will not therefore lead to an assessment of whether individuals suffered an injustice because the present or past domestic regime for the regulation of insurance companies was not compatible with European legislation on the protection of investors.

(ii) Secondly, the Ombudsman cannot consider complaints about the regulation of Equitable Life in the period after 1 December 2001 as the Financial Services Authority, which (among other duties) now regulates the insurance industry, is not a body within the Ombudsman's jurisdiction.

The Ombudsman's investigation will not therefore lead to an assessment of whether individuals have suffered an injustice due to any maladministration on the part of those charged with regulating Equitable Life since the new regime came into force almost four years ago.

(iii) Thirdly, while the Ombudsman's investigation will address complaints about the actions of those charged with the prudential regulation of Equitable Life prior to December 2001, the Ombudsman cannot consider complaints about conduct of business or marketing issues in the same period. This is because the self-regulatory bodies, including the designated agency, that were responsible for such regulation are not – and have never been – within the Ombudsman's jurisdiction.

The Ombudsman's investigation will not therefore lead to an assessment of whether individuals suffered an injustice due to any maladministration on the part of those charged, in the period prior to December 2001, with the regulation of the sale and marketing of Equitable Life's products to its then current and prospective customers.

Other matters

23. It is expected that the report of the investigation will be published in Spring 2006.

24. Should the Committee require further information, the Ombudsman would be happy to assist their deliberations to the extent that she can.

Annex A

Further information

More about the role of the Ombudsman and about her current investigation is available from the following sources:

1. Website

http://www.ombudsman.org.uk/

2. Report to Parliament, following consultation on whether to initiate a further investigation

http://www.ombudsman.org.uk/improving_services/special_reports/pca/equitable/index.html

3. Annual Report 2004-05

http://www.ombudsman.org.uk/about_us/our_plans/annual_reports/ar05/index.html

4. Terms of reference for investigation (see also Annex B)

http://www.ombudsman.org.uk/improving_services/special_reports/pca/equitable_tor05/equitableSOC04.html

Annex B

Terms of Reference and Statement of Complaint for the Equitable Life Investigation

Investigation terms of reference

The terms of reference for the investigation 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.*

Statement of complaint

Summary of complaint

The complainants complain that the public bodies responsible for the prudential regulation of insurance companies (successively the Department of Trade and Industry, Her Majesty's Treasury and the Financial Services Authority, collectively referred to in the rest of this statement as 'the regulators') and the Government Actuary's Department (GAD) failed for considerably longer than a decade properly to exercise their regulatory functions in respect of the Equitable Life Assurance Society (ELAS) and were therefore guilty of maladministration.

Specific complaints

1. Organisational issues

a. The regulators were not sufficiently resourced, and did not all possess the necessary skills, to contribute effectively to the overall regulatory process and to responsibly exercise their discretionary powers as intended by Parliament and by the European Community (now the European Union). Administrative decisions as to resourcing, priorities and methods contributed to a position in which the regulators did not properly undertake their functions as prudential regulator of ELAS.

b. The regulators failed to liaise and to co-operate effectively with those responsible for the regulation of the conduct of business by insurance companies. In particular, they failed to ensure that proper assessments were made of ELAS's individual practices and its communications with policyholders, and of the expectations that these generated, in the light of the information that was, or should have been, known to the prudential regulators.

2. General operational issues

c. The prudential regulators did not operate the regulatory regime as it was intended to be implemented by Parliament and in conformity with EC Directives. The regulators instead chose to regulate ELAS with a ‘light touch’ – a concept not evident from or provided for under the Insurance Companies Act 1982 and the EC Third Life Directive nor one consistent with these statutory provisions. The approach to the regulation of ELAS was exceptionally and unjustifiably lenient when compared to that adopted with other companies, with inadequate investigative site visits and lack of liaison with conduct of business regulators. Much more rigorous standards of supervision and better co-operation with conduct of business regulators were adopted for smaller and unit-linked companies. This demonstrated that the regulators applied a two-tier standard of regulation.

d. The regulators and GAD allowed successive chief executives or managing directors of ELAS also to hold the post of appointed actuary, despite recognising the potential for conflict of interest in this position. These decisions were not consistent with the basis of the regulatory regime.

e. The regulators and GAD failed to keep pace with developments in the pensions and life insurance industry and to assess and adapt their methods to reflect those developments. This was particularly critical in a situation in which narrow, technical interpretations of regulatory solvency were becoming an increasingly irrelevant measure of any insurer’s realistic financial position as the industry moved more and more towards non-guaranteed bonus declarations.

f. GAD had recommended ELAS as a pension plan or additional voluntary contribution scheme provider in its advice to the administrators of the Principal Civil Service Pension Scheme and to other public sector pension schemes. This led to a lack of proper separation of its responsibilities and to a clear conflict of interest between GAD’s role in providing advice to government bodies in relation to public sector pensions and in assisting the prudential regulators of ELAS. This conflict of interest compromised the proper discharge of GAD’s regulatory functions.

3. Supervision of regulatory solvency

g. From the mid 1980s until 1997, the regulators failed to evaluate the potential effect of Guaranteed Annuity Rates (GARs) on the solvency of ELAS in a context where current annuity rates were falling steadily, in line with the Bank of England’s base rate, to below contracted GARs. The regulators learned explicitly in November 1993 of the degree of ELAS’s exposure to risks associated both with the GAR issue and with ELAS’s lack of prudent reserves. The regulators’ failure to take action then or to impose reserving until 1999 played a direct part in the closure of ELAS to new business and to subsequent cuts in policy and annuity values. The regulators did not prepare a study on the extent of GARs in the industry until 1997: a decade too late.

h. From about 1990 onwards, the regulators and GAD failed to give sufficient consideration to the fact that some of the measures used to bolster ELAS’s solvency position were predicated on the emergence of a future surplus. As a consequence, they did not properly assess the overall impact and adequacy of those measures. The regulators also allowed ELAS to mis-use the term ‘surplus’ and failed to consider the use of that word in the context of policyholders’ reasonable expectations.

i. Over this same period, the regulators allowed ELAS to publish financial results and projections that were misleading in that they did not reflect the Society’s true position. In particular, ELAS was allowed to habitually report growth rates alongside bonus rates, which gave the impression of a prudent margin for error, whereas the true position was that:

- assets were consistently less than policy values so that higher rates of growth were needed to cover any given rate of bonus; and
- as part of the growth was needed to cover expenses and the contractual liability for conventional annuities, the growth available to meet with-profits bonuses was always materially less than the rate quoted in ELAS literature. This was never made clear.

j. During this period, the regulators and GAD failed to act when ELAS adopted what Lord Penrose described as practices of ‘dubious actuarial merit’. These included valuing future liabilities at an inappropriate rate of interest between 1990 and 1996; treating selling costs as an asset; making no provision for GARs until much too late; valuing a financial re-insurance policy (which proved to be of no value) at over £800 million; allowing credit for ‘aspirational’ (i.e. effectively unrealisable) assets; responding too slowly to widely evidenced changes to mortality expectations; and the issuing of a subordinated debt worth £346 million which did not count as a liability.

k. On several specific occasions, as set out in the Penrose report, the regulators and GAD ignored or failed to act on information that might have led to formal or informal regulatory action against ELAS, thus also failing to alert new investors to the risks of investing. These include when ELAS board papers were sent to GAD by the appointed actuary on 11 June 1991, and when information was provided to GAD on 10 September 1992 which showed that, for the years 1989 to 1991, the aggregate policy values very significantly exceeded the value of the underlying assets.

4. Payment of excess bonuses

l. Over a period of many years the regulators and GAD permitted ELAS to operate an unsound business model, of which they were aware. ELAS had made public its policy of reliance on ‘goodwill’ in a 1989 actuarial paper *With Profits Without Mystery*, but the regulators never addressed the issue or challenged ELAS about it or about the consequences of the model. Instead, they allowed ELAS to operate the model, which entailed declaring bonuses in excess of admissible assets, while at the same time operating without a significant estate and with a smoothing fund persistently in deficit. These were major contributory factors to ELAS’s development of what Lord Penrose quantified as a £3 billion asset deficit at the time of closure to new business and to the losses incurred by all those who held policies on 16 July 2001.

m. The regulators failed to ensure any satisfactory correlation between the total of declared policy values and ELAS's admissible assets in a context where ELAS, uniquely in the industry, had declared total policy values that included terminal bonuses and had, without exception, always paid all claims (both contractual and non-contractual) in accordance with these declarations.

5. Policyholders' reasonable expectations (PRE)

n. Ministers and officials decided that regulatory activities in relation to safeguarding PRE should be based solely on the regulatory returns, but failed to put in place adequate procedures and Regulations to enable this to be achieved. This failure was particularly critical in respect of ELAS, which had unique practices that elicited PRE.

o. As a result, the regulators and GAD failed over many years properly to monitor and assess ELAS's asset position and its practices in the light of PRE. The regulators and GAD did not properly determine PRE or act to protect them as intended by Parliament and to the standards set by EC Directives.

p. During the course of the Hyman litigation, the regulators failed in their duty to all policyholders in respect of PRE and postponed consideration of issues related to assets and reasonable expectations, both for GAR and non-GAR policyholders, until after the House of Lords judgment (20 July 2000). In addition, the regulators totally failed to assess properly either the impact or the scope of the judgment and to evaluate the range of scenarios for ELAS following it. They failed to take appropriate action to mitigate the adverse affect of the judgment on the majority, non-GAR policyholders, and on new investors into the same with-profits fund. Their judgement that there was a 99.9% probability that ELAS would be sold demonstrated that, despite the extensive information that they possessed, the regulators failed to understand the parlous state of ELAS which was apparent to all prospective bidders.

q. In March 2001, the regulators permitted ELAS to declare a bonus for 2000 and an interim bonus for 2001 that were both inappropriate and unjustifiable given the then state of ELAS's finances, thus raising misleading expectations about the true state of ELAS just prior to significant across-the-board cuts that were imposed only four months later. Instead, ELAS's asset deficit of 13% at year-end 2000 in a closed fund should have precipitated regulatory intervention at that time.

r. In July 2001, the regulators failed to protect PRE by permitting policy value adjustments worth more than £4,000 million in the form of an inequitable uniform percentage cut across all with-profits policies, rather than the fairer alternative of reducing policy values by cutting only non-guaranteed bonuses. The regulators also refused to comment meaningfully on this to policyholders while discouraging independent financial advisers from giving proper advice to policyholders.

Remedy sought

The complainants seek full financial redress for the losses they have incurred in consequence of the maladministration outlined above.