

8 March 2004

**STATEMENT GIVEN TO PARLIAMENT BY THE FINANCIAL
SECRETARY TO THE TREASURY, RUTH KELLY ON THE
PENROSE INQUIRY INTO EQUITABLE LIFE**

1. Mr Speaker, with permission, I would like to make a statement about Lord Penrose's report into the events at Equitable Life, which I can confirm is being published in full today. Copies are available in the Vote Office.
2. As the House will remember, following the closure of Equitable Life to new business and the cuts in policy values in July 2001, the Government established an independent inquiry under Lord Penrose on 31 August 2001. The terms of reference were:
3. *“To enquire into the circumstances leading to the current situation of the Equitable Life Assurance Society, taking account of relevant life market background; to identify any lessons to be learnt for the conduct, administration and regulation of life assurance business; and to give a report thereon to Treasury ministers”.*
4. I would personally like to thank Lord Penrose and his team for their hard work and dedication. The report presents a full and forensic account of events, covering some very complex issues and spanning a period of over 30 years.
5. The Government sympathises with the plight of policyholders who have suffered much worry and distress over the past four years and who have seen significant reductions in their expected income in retirement.

6. Mr Speaker, Lord Penrose says: “I have interpreted the remit [of the inquiry] as requiring me to focus on the events that explain the Society’s fate.” (Foreword, 11). He also makes clear that “it was inevitable that hindsight would instruct much of the inquiry’s work and many of its findings (Foreword/8).
7. He does not attempt to judge any person’s actions saying: “It was not for me to measure any person’s actions against accepted standards of conduct defining the legal duties of other people performing comparable duties in other organisations and other similar circumstances” (Foreword/8).
8. He observes: “Breach of duty, and the financial consequences of breach, are properly matters for the established courts of justice and for other appropriate tribunals in the financial sector”, (Foreword/9).
9. He adds: “An open adversarial process such as would have been necessary to replicate the litigation process over the longer period and the wider range of issues would have been beyond contemplation” (20/77).
10. “It would”, he said “be unthinkable for a [non-statutory, non-adversarial] inquiry such as this to have embarked on such a process” (Foreword/10). And moreover, “There was no mechanism” he says “that could have been devised and put into effect within a time scale that would have had

regard to the wider public interest in obtaining the account of the developments of the Society's position...."
(Foreword/10).

11. Lord Penrose argues that the judgement of the House of Lords in the Hyman case in 2000, which disallowed the Society's practice of reducing terminal bonus to meet guaranteed annuity claims, precipitated a crisis, but was not – as some have claimed – solely responsible for it. He notes: "Superficially claims of £1.5 billion should not have brought down a Society with funds of £32 billion."(2/113)
12. Mr Speaker, Lord Penrose observes: "The Society's uniqueness lay in the approach adopted by its management, not in the essential characteristics of its business."(19/119)
13. Mr Speaker, Lord Penrose describes how a culture of manipulation and concealment on the part of some of the company's previous senior management allowed a bonus policy to develop that led to the Society's financial weakening – a policy left unchecked by its own Board. It was the Society's own actions which ultimately precipitated its financial crisis in the summer of 2000.
14. First, the report details how executive management failed to keep the Board fully informed about the true state of the company's financial position, despite the clear

responsibility placed on the Appointed Actuary to inform the Board in that regard.

15. Mr Speaker, Lord Penrose outlines how, Mr Roy Ranson, Appointed Actuary from 1982 and both Chief Executive and Appointed Actuary of the company between 1991 and 1997 **did not inform the Board:**

- “of management decisions in the period 1983-93 related to the recovery of the cost of annuity guarantees from terminal bonus” (19/126)

did not inform the Board:

- “of the risks to which policyholders not entitled to annuity guarantees were exposed by the policies and practices adopted” (19/126),

and did not inform the Board:

- “about the business risks inherent in the general actuarial management of the Society” (19/126).

16. Mr Speaker, this meant, Lord Penrose says: “the Board’s understanding of the annuity guarantee issue was at best limited until the autumn of 1997, and some directors may not have had any understanding of the position” (9/45).

17. As a result, Mr Speaker, the decisions of the Board “brought the Society to the position of weakness in which it

found itself in 2000 and 2001 without full knowledge and understanding of the developing position” (19/88).

18. He does not offer judgement on Mr Ranson’s failure to keep the Board adequately informed. In line with his interpretation of his remit, he says: “I have not sought to form or express a view whether Ranson was in breach of duty...that is a matter for the courts and for his professional institute” (19/119).
19. But, Mr Speaker, Lord Penrose observes: “The Board at no stage got fully to grips with the financial situation faced by the Society: information was too fragmented, their collective skills were inadequate for the task, and there were no effective arrangements for ensuring that there was detailed examination of, and onward reporting to the Board, on actuarial reports” (20/50).
20. He adds: the “non-executive directors were so wholly dependent on actuarial input from the chief executive/actuary that they were largely incapable of exercising any influence on the actuarial management of the Society” (20/50).
21. Mr Speaker, Lord Penrose also finds there was “Serious omission in communication to policyholders of relevant information about their prospective interests” (19/24). He reveals how the differential terminal bonus policy “was not

disclosed to policyholders in any way until 1996.
(19/24).

22. Even when the company decided to inform policyholders about the terminal bonus policy in 1996, Lord Penrose argues that it was done badly: “Attempts were made to change expectations in 1996 and later years. These were ill-conceived, poorly expressed and confusing. The intimations to policyholders were generally uncommunicative.” (19/72).

23. Lastly, Mr Speaker, Lord Penrose finds that the Society concealed information from the regulators. Mr Ranson was “obstructive” of scrutiny and “dismissive” of regulators concerns. The regulatory returns were, Lord Penrose says “opaque and uncommunicative” (19/129).

24. The Society did not inform regulators properly about: “a series of particular valuation practices of dubious actuarial merit” (19/240(5)) being used by management to sustain the Society’s capital position and prop up its solvency.

25. Mr Speaker, Lord Penrose reveals how from 1992 to 2000, “the Society never clearly communicated the nature of its quasi-zillmer adjustment to GAD” (7/24), an adjustment which “was not a legitimate device on the terms of the regulations” (7/26).

26. And Lord Penrose finds in relation to guarantees, that “Such references as were made...failed properly to disclose their nature and extent to the regulators” (19/128).
27. More recently, Lord Penrose observes the then Appointed Actuary, Mr Christopher Headdon, wrote a crucial side letter relating to a reinsurance contract, which recorded that it would be cancelled rather than renegotiated in the event that more than £100m was claimed.
28. Lord Penrose notes that had the FSA been made aware of this side-letter, “they ‘would not have been prepared to accept the reinsurance arrangements as providing as much security for reserving purposes as was in fact taken’”. (7/93).
29. Lord Penrose writes: “Those involved at the Society were not in any doubt that a right for the reinsurer to cancel in these circumstances would undermine the regulatory value of the agreement” (7/96).
30. Lord Penrose says: “These matters are potentially the subject of other proceedings, so I do not propose to comment on what may or may not have been the intention in writing the side letter or its legal effect”(7/96).
31. In short, Mr Speaker, Lord Penrose makes clear that the Society’s former management adopted a series of

“dubious” practices many of which it concealed from its own Board, its policyholders and the regulators.

32. This, he argues, led to the situation in which the Society found itself in July 2001. It meant that, Lord Penrose says “the Society was able to over-allocate bonus beyond available assets at market value, and in particular to make payments on claims that exceeded the relative available assets at the time” (19/49), weakening the Society so greatly that it was unable to withstand the claims on guaranteed annuities.

33. Mr Speaker, Lord Penrose’s central finding is that “principally, the Society was the author of its own misfortunes” (20/84).

34. The House will be aware that Lord Penrose sent his report to the Serious Fraud Office. The Treasury followed up by passing the report to the enforcement arms of the FSA and DTI. All three are currently considering the evidence of the report.

35. Mr Speaker, as I have described, Lord Penrose, lays the blame for events at Equitable Life at the heart of the Society. He calculates that by the end of 2000, as a result of the excess bonus declarations, the Society’s liabilities exceeded its assets and £1.8 billion had been lost to the fund as policies matured taking more than their fair share

of assets. This past overbonusing was a driving factor, he says, behind the need to cut policy values in July 2001.

36. The current management argues strongly that the cuts in policy values in 2001 reflected different factors. The House will appreciate that this is a complex legal, actuarial and accounting issue, which could ultimately only be determined by the Courts.
37. Lord Penrose himself makes clear that he could not “adjudicate on the policyholders’ complaints and claims: that again is a matter for other proceedings” (Foreword/14).
38. It was important however that the Government acted with due diligence to check with the FSA the potential impact of these complex issues on the Society’s current policyholders and on wider financial stability. This is why we have been unable to publish the report earlier.
39. The current Board of Equitable Life will together with the FSA assess the impact on the Society’s liabilities and any risks to policyholders posed by Lord Penrose’s findings. Those who have already seen limited extracts of the report on behalf of Equitable’s Board have concluded that it is in the best interests of policyholders to continue in business as before.
40. To conclude on overbonusing, Lord Penrose himself makes clear on claims that “that again is a matter for other

proceedings” (Foreword/ 14). And the FSA will continue to monitor the Society closely and take whatever action is needed to protect policyholders.

41. Mr Speaker, Lord Penrose raises a number of important issues about the deregulatory, light-touch, reactive system in the decades before the creation of the FSA. It was a system, however, which in that period clearly reflected the will of Parliament.
42. He finds that the “lack of coordination of prudential and conduct of business regulation was unacceptable” (20/64) and that “the accounts did not reflect the realistic [financial] position of the office” (20/27).
43. In 1997, as soon as this Government came to power, it took action to put an effective regulatory system in place, setting up a single integrated regulator combining prudential and conduct of business regulation. A key part of the new regulatory regime was the creation of a comprehensive Financial Services Compensation Scheme and a single financial ombudsman service.
44. Since then, the FSA has proceeded to introduce risk-based insurance regulation and individual capital standards. It is also in the process of introducing realistic accounting by life offices, including a requirement to reserve for terminal bonus. In addition, the use of future profits implicit items is being phased out.

45. The FSA is also removing responsibility for making key decisions on asset allocation and distribution in with-profits funds from the Appointed Actuary and transferring it to company boards. And it has brought forward proposals on better treatment of customers by firms and fuller transparency of with-profit funds.
46. Lord Penrose fully endorses the Government's actions since coming to power, saying that the FSA's reforms reflect "a major, comprehensive reassessment of the requirements of an efficient regulatory system for the insurance sector". (App E/ 3).
47. In particular, he welcomes the FSA's detailed proposals for realistic accounting which, he says, "are clear recognition of the importance of looking beyond a narrow concept of solvency" (19/165).
48. In summary, he argues that the FSA's work since 1997 "has sought to anticipate many of the lessons that might be drawn by this inquiry and it should come as no surprise that it has largely succeeded." (20/3).
49. However, Mr Speaker, Lord Penrose's report deals with a time when a different regulatory system was in place – and a regulatory culture that was light-touch, reactive and placed the responsibility for monitoring policyholders' reasonable expectations firmly on the Appointed Actuary of

companies. A regulatory system that was argued for by Ministers and reflected the will of Parliament.

50. Lord Penrose notes that in 1973, during the passage of the Insurance and Companies Act, DTI ministers resolved “that action on the basis of policyholders’ reasonable expectations would be reactive to what was found in the [annual regulatory] returns so as to restrict the workload that a less restrained approach would involve” (13/56).
51. Lord Penrose argues that the system was not updated to take account of developments in the industry, particularly the trend towards terminal bonuses. He notes that aspects of the regime were reviewed, but that no proposals for change were pursued by Ministers. He writes: “Virtually no primary legislation in the regulatory area for which DTI was responsible was taken forward by Ministers...there were specific proposals for change that Ministers did not pursue” (19/162).
52. In particular, a proposal was made in 1988 to update life insurance regulation. But he says: “the minister...[the Rt Hon Gentleman for Bromley and Chislehurst] did not regard the subject as a high priority for legislation”, (13/116).
53. Mr Speaker, Lord Penrose notes that senior regulatory officers argued to him that, “the Government required a ‘light touch’ approach to regulation, and allocated

resources accordingly” (19/161). “I was urged”, he says “to take into account the political climate that prevailed for most of the 1990s when the Government’s objective was to deregulate, to reduce regulatory burdens on business, to avoid interference in private companies, and to let market forces prevail” (19/161).

54. Mr Speaker, Lord Penrose goes further. He says ministers argued against reform in the early 1990s – a critical time of development in the industry - when the 3rd Life Directive was being negotiated in Brussels, maintaining that the reactive approach to PRE based on regulatory solvency was sufficient.
55. According to Lord Penrose, DTI believed that forcing insurance companies to reserve for terminal bonus would have been “over cautious” (10/26). And Lord Penrose says that the UK delegation “led the resistance” to measures requiring more cautious valuation techniques (10/28).
56. Mr Speaker, Lord Penrose says: “As for the regulatory system, I do believe it has failed policyholders in this case” (20/83). He emphasises, however, that “regulatory system failures were secondary factors” (20/84), and argues that it was “the system that failed to provide the regulation that changing circumstances in the industry required, not that there was failure to implement what was fundamentally a satisfactory system” (20/69). That system was one that Ministers and Parliament intended.

57. Lord Penrose makes no recommendation for the payment of compensation. His central finding is that “principally, the Society was the author of its own misfortunes.” (20/84). And when he itemises specific findings about the regulator he is clear that these are matters that are not for him but for the courts. Nor does he conclude economic loss was caused to policyholders by the regulatory system. Mr Speaker, Lord Penrose states: “The deficiencies are not so obvious as some are inclined (or wish) to believe. And it is not enough in this case, to infer from the coincidence of systems deficiencies and loss that one caused or contributed to the other”. (20/84). He stresses that he examined the regulators with the benefit of hindsight and that they were operating under a system different in its approach, resources and values from that applying today. The misfortunes of the Society were caused primarily, he finds, by deep-seated management problems which began as early as the 1980s.
58. Mr Speaker, he makes no allegation of maladministration nor of negligence against the regulator. He clearly establishes, with the benefit of hind-sight, that the “light-touch” approach to regulation was inappropriate. It was not updated to meet the requirements of the industry. But it clearly reflected the will of ministers and Parliament.
59. He says: “Ministers resolved that scrutiny would continue to be based on the examination of the regulatory

returns, and that action on the basis of policyholders' reasonable expectations would be reactive to what was found in the returns". (13/56)

60. So it is a question of the laws that Parliament enacted and the context in which Ministers resolved how those laws should be implemented which Lord Penrose criticises rather than the discrete actions of regulators.
61. Indeed, Lord Penrose accepts that it cannot be the role of the regulator to prevent all failures. The costs of regulation are paid ultimately by the customers, rather than by the institutions themselves.
62. Mr Speaker, Lord Penrose accepts that even had a different, pro-active regime been in place earlier, no regulator can guarantee to protect consumers against concealment and manipulation. Indeed the losses suffered by policyholders are attributed by Lord Penrose to decisions that were made by the management of the Society from the early 1980s onwards.
63. He observes: "by appearing to insulate consumers entirely from the risk inherent in the selection of an investment product such an approach could give rise to perverse economic incentives for both consumers and providers" (20/70).

64. This position is, I know, shared widely across the House. In July 1995, the then Chancellor of the Exchequer, the Rt hon Member for Rushcliffe said: “I should like to remind the House of an important point. No regulatory system can provide a 100 per cent guarantee against failure, especially where there is a deliberate intention on the part of individual traders to conceal or deceive, combined with inadequate management controls. In cases such as this, it is important that lessons are learned quickly and promulgated widely, so that all parties, including the management of other financial institutions, can learn from the unfortunate example”. (18 July 1995, Column 1457).

65. Mr Speaker, many people have drawn parallels between Equitable and Barlow Clowes. It has been put to us that as the then government provided redress in the Barlow Clowes case we should do so with respect to Equitable. But there are major differences between the two cases. Barlow Clowes had ceased trading; Equitable is still trading. In the case of Barlow Clowes there was a finding of maladministration; here there has been no such finding. At the time of Barlow Clowes there was no compensation scheme; now there is the Financial Services Compensation Scheme. Those who continue to argue that what happened over Barlow Clowes should also happen here in the case of Equitable Life have got to take into account both the existence of a compensation scheme and no finding of maladministration.

66. Mr Speaker, in the event that Equitable were to be subject to insolvency proceedings there is now, what was recognised not to be available at the time of Barlow Clowes, a statutory safety net to protect investors provided by the Financial Services Compensation Scheme, which would pay out 90% of guaranteed policy values.
67. 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 policyholder who have made claims for redress, for which the Society has already made provisions.
68. 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.
69. As I have made clear, Equitable's current board stress that the company is solvent and policyholders' interests are best served by remaining in business.
70. Mr Speaker, in his report Lord Penrose raises a number of issues concerning the unlimited liability status of Equitable Life. I can announce today that the Government intends to publish and consult on, at the earliest opportunity, draft legislation to protect policyholders in the event that this were ever to become material.

71. Mr Speaker, in line with his interpretation of his remit, Lord Penrose does not set out a comprehensive list of recommendations for the Government. Nevertheless, he does make a number of observations which merit further action. I have no doubt that Committees of this House which have taken an interest in these matters will wish to examine what further can be done. But the principal that the regulatory system – even one so recently updated – should be subject to constant review is one that we accept. Mr Speaker, I can announce today a programme of work to build on Lord Penrose’s findings.

72. The Government accepts the need to re-examine the corporate governance arrangements applicable to mutual life offices in the light of the experience at Equitable Life. I can today announce a review of the governance of mutual life offices, to be led by Paul Myners, so that the boards of mutual life offices are as accountable to their members as those of comparable companies are to their shareholders.

73. Lord Penrose also offers a number of criticisms of the actuarial profession. He says: “The profession resisted prescription. The individual judgement of the appointed actuary prevailed.” (13/101).

74. He adds: “the guidance offered no standards of performance that might reflect generally accepted

principles or rules of conduct such as one might have expected of a professional body” (13/58).

75. I can announce today that Sir Derek Morris will lead a review of the actuarial profession with a particular focus on considering how best to modernise the profession and see that high standards are delivered in a more open, challenging and accountable professional culture.
76. I can also announce that I have asked the independent Accounting Standards Board to initiate a study into the accounting for with-profits business by life insurers. The study will have a particular emphasis on identifying ways of improving the transparency of reporting.
77. Lord Penrose also argues that there is a clear responsibility on government to inform and educate consumers about the nature of the financial system. This Government was the first in the world to incorporate consumer education as a key statutory objective of the financial services regulator. And the FSA have recently stepped up their work in this area, with the launch of the Financial Capability Steering Group, which will examine the approach to consumer education from first principles.
78. Mr Speaker, I have today set out Lord Penrose’s account of events leading to the situation in which Equitable Life found itself in July 2001. Lord Penrose finds that “the first and most significant failure identified in this report lay at the

heart of the Society". But he adds that a key lesson from the report is that "it is important to ensure that the continued relevance of the regulatory tools is regularly assessed in the light of a constantly developing industry, and to ensure that those tools are diligently and intelligently applied" (Letter, 11). "It seems not unreasonable to suggest" he says "that those in control of any supervisory regime have a duty ... to take steps to ensure that the systems of regulation that are in force and enforced remain relevant to the changing requirements of the industry" (19/205). Mr Speaker, we made those changes.

79. Mr Speaker, inevitably certain key issues arising from Lord Penrose's report, as he recognises, can only be resolved in the Courts.
80. Nevertheless as a result of his findings, we will be publishing and consulting on draft legislation to remove any possible concerns relating to unlimited liability potentially facing Equitable Life and some other policyholders.
81. We stand ready, if requested, to assist the Financial Services Ombudsman in the resolution of any consequential issues before him and his staff.
82. The FSA is working intensively to ensure that all its current policyholders are treated fairly.

83. Looking forward there will be a programme of comprehensive reviews – on corporate governance of life mutuals, actuarial standards of performance and accounting standards. These, alongside the FSA reforms welcomed by Lord Penrose, are developing the architecture of the life assurance industry for present and future policyholders.

84. Mr Speaker, it is now for the Serious Fraud Office and the DTI to decide whether a prosecution should follow.