Financial Ombudsman Service

ADJUDICATION	
Complainant(s):	Mr H
Firm:	The Equitable Life Assurance Society
Date of Adjudication:	6 April 2006

Complaint

Mr H has complained about Equitable Life's sale to him in January 1998 of a with-profits Personal Pension Plan. He has complained that Equitable Life failed to disclose to him, either through its representative or in the literature that it supplied at the time, the fact that some pension policies that it had issued before mid-1988 included rights to a minimum guaranteed annuity rate ("GAR") available when converting the policy benefits into pension benefits on retirement, and that these GAR rights might have a potential cost to the with-profits Fund and so might act to the detriment of his own with-profits investment. Mr H has complained that if the firm had disclosed this he would not have taken out the investment and he has asked for compensation.

Mr H is within the category of policyholders who did not have any rights to a GAR themselves – a category which we refer to as "non-GAR policyholders". The "GAR-related risk" in this context was thus the impact that any GAR-related claims on the with-profits fund by the GAR policyholders would have on the non-GAR policyholders (or potential non-GAR policyholders such as Mr H when he was receiving advice).

Mr H has also raised a further issue in respect of the statement that [the representative] made in his letter to him of 11 November 1997: "*The Equitable's Personal Pension Plans are essentially the same in structure as the retirement annuity contracts that have been available since 1956 – differing only in name and the legislation under which they are approved."*

On 26 August 2003 Equitable Life made Mr H an offer, without admission of liability, of £633.04 in respect of his GAR-related claim. He decided not to accept this offer, which lapsed on 21 October 2003 and so the matter has since been referred to us to consider.

Circumstances

In January 1998 Mr H made a with-profits investment of £12,000 into a personal pension plan with Equitable Life. Equitable Life did not at that time disclose to new investors in its literature that since 1994 it had operated a differential terminal bonus policy (DTBP) for policies containing a GAR. In effect, the DTBP meant that when the pension policy was used to set up an annuity, the amount of terminal bonus payable was adjusted according to whether or not the policyholder elected to exercise his right for a minimum guaranteed annuity rate to be applied to the fund value of the policy in calculating the amount of annuity to be received. The firm believed that it was entitled to apply the DTBP under Article 65(1) of its Articles of Association.

There would appear to be no dispute that Equitable Life did not disclose the GAR related issue to Mr H at that time, principally because it did not believe that it was under a duty to do so. In the event, Equitable Life's right to operate a DTBP was challenged in the Courts, and in July 2000 the House of Lords ruled that Equitable Life was not entitled to adopt a DTBP and had acted in breach of Article 65(1) of its Articles of Association by doing so.

I note that Mr H made further contributions of £4,000 in October 1998 and £5,000 in March 1999 into the Personal Pension Plan with Equitable Life. He also received advice from a further representative of Equitable Life in October/November 1998 to transfer benefits from a with-profits Personal Pension Plan with Legal & General into Equitable Life, but Mr H did not act on that advice, so I shall not be considering this matter further here.

In December 2001 Mr H transferred his fund from Equitable Life to AXA Sun Life.

Our conclusions on other related matters

Mr H's complaint is one of a large number of complaints against Equitable Life that the Financial Ombudsman Service has been considering which are known as "GAR related complaints". These complaints have been subject to extensive debate by the parties and an intensive investigation by the Financial Ombudsman Service.

We have given this matter our most careful consideration. Our investigations have included looking at the relevant documentation that is within the public domain such as the report by Lord Penrose which was issued in March 2004 following his in-depth inquiry into Equitable Life; it is available at:
www.hm-treasury.gov.uk/independent_reviews/penrose_report/indrev_pen_index.cfm .

We also looked at developments in the recently concluded legal action brought by Equitable Life against its former auditors and directors, in case such action brought to light any new evidence that would have been material to our assessment of the GAR-related complaints.

In reaching a view in this case, I have taken into account the conclusions we have reached on the other "lead cases" on GAR related complaints made against Equitable Life. Each of these cases has been published on our web-site and is available at www.financial-ombudsman.org.uk/faq/equitable.htm. I will, however, set out the brief details of these cases below by way of background to my assessment in this case.

a) Ms E – a sale that took place in October 1999

In a decision dated 22 March 2005 concerning a complainant known as Ms E, the chief ombudsman considered a similar sale that took place in October 1999. He set out in his final decision the background to this matter and the knowledge of the firm at the date the advice to Ms E was given. He noted that at the time advice was given to Ms E, Equitable Life had already been warned by its legal advisers that the courts might decide that the way it was running its with-profits fund to negate the value of GAR rights was not permissible. Equitable Life had been advised that if this happened it might make the GAR rights costly for it.

The chief ombudsman concluded that Equitable Life's representative had not drawn Ms E's attention to this risk and that he ought to have done so. Accordingly Equitable Life had failed in its duty to advise with reasonable skill and care and to disclose to her all material risks of the course of action it recommended to her. He was satisfied that if Ms E had received full and proper advice she would not have invested with Equitable Life but would instead have invested with another firm's with-profits pension fund which was not subject to similar risks. He required the firm to compensate Ms E according to a formula that related her loss to the benefit she would have obtained from a "market average" of alternative with-profits pension investments.

b) Mr G - a sale that took place in March 1998

Subsequently, we considered the case of Mr G who had received similar advice from Equitable Life in March 1998. We noted that at that time Equitable Life had started to consider the GAR-related risk internally and, based on the number of complaints it was starting to receive, was (or at least should have been) aware that its stance on paying a differential terminal bonus was subject to a potential challenge.

We concluded that by 20 March 1998 the state of culpability of Equitable Life's senior management was the same as in the Ms E lead case and that therefore the complaint should be upheld and redress paid in accordance with the formula previously set out in the Ms E case.

The complainant accepted the conclusions and Equitable Life decided not to challenge them.

c) Mr N - a sale that took place in 1990

In the case of Mr N we considered the sale of a with profits policy in 1990. When the advice was given in 1990, current annuity rates (CARs) were substantially higher than GARs, and our view was that the risk posed to the firm by honouring any GARs was therefore hypothetical in nature. In fact, the GAR only exceeded the CAR for the first time in the period from October 1993 until May 1994, and thereafter from May 1995 onwards.

In Mr N's case, we found that there was no evidence to suggest that at the time of the advice and sale of Mr N's policy, Equitable Life knew (or ought to have known) that the existence of the GARs and the potential application of the DTBP represented anything other than a theoretical risk. In essence, we concluded from the evidence available that even if Equitable Life had disclosed this GAR-related risk, the perceived risk itself was so small as to be insignificant, and that Mr N would still have entered into the contract. Mr N did not challenge our view.

Findings

The sale to Mr H took place in January 1998 which falls within the period from 1990 (covered by the Mr N case referred to above) and March 1998 (covered by the Mr G case referred to above).

I understand that at the point of advice and sale, Mr H did not ask about the GAR risk, nor was it mentioned by Equitable Life's representative.

The regulatory and legal background to the general issues raised in relation to the disclosure of the GAR risk is set out fully in the chief ombudsman's decision on Ms E and so I need not repeat this here. Suffice to say, I am satisfied on the facts that the firm owed Mr H a duty of care to give him full and proper advice as to the potential benefits and risks of entering into a personal pension with Equitable Life.

The firm had a legal duty to advise with reasonable skill and care and a regulatory requirement to provide suitable advice and explain the material risks involved in relation to the advice. In considering whether the firm breached this duty, I need to consider whether it ought to have disclosed the GAR related risk to Mr H at the time advice was given. If the firm did not know or could not reasonably be expected to know that those risks were material, I cannot conclude that it breached its duty to Mr H in this regard.

As a starting point for my assessment, I am satisfied on the evidence I have seen that Equitable Life's senior management, and other senior actuaries and managers in the life insurance sector, understood prior to March 1998 (the date referred to in the Mr G case above) that there was a potential issue with GARs. I have reached this conclusion based on the understanding of the sector at the time, including the fact that in January 1997 the Life Board of the Institute and Faculty of Actuaries set up an Annuity Guarantees Working Party which reported in November of that year. Its report "Reserving for Annuity Guarantees" may be seen at:
www.actuaries.org.uk/files/pdf/library/annuit_report.pdf.
This report "*identified a number of possible approaches for consideration*" in respect of reserving for annuity guarantees, and in summary these were: (1) setting aside additional reserves based on a prudent estimate of the cost of the guarantees; (2) recognising the cost of the guarantees as effectively increasing the guaranteed sum assured and then recalculating the net premium reserves accordingly; and (3) not reserving for the guarantees but making adjustments to the terminal bonuses payable.

The report went on to state that each of these options had its own advantages and disadvantages and that “no approach is entirely satisfactory”. The basis on which the reserving would take place in each of the first two approaches was questioned. On the other hand, it was noted that the approach of not reserving for guarantees “*could be viewed as being unsound because no explicit provision is made for an explicit guarantee*”. However, in its conclusions the working party felt unable to recommend a common approach to reserving or indeed in dealing with the GAR issue.

In terms of how the GAR problem developed, the origins can be found in the combined effect of lower interest rates and lighter mortality experienced over the course of the past decade or so. Whilst companies can see changes in interest rates as they develop, lighter mortality rates are not seen on the same daily basis, and can only be seen over a longer period.

The relevant facts in respect of the GAR problem are also mentioned in Chapter 4 of the Baird Report of 2001, the text of which may be seen at : www.hm-treasury.gov.uk/newsroom_and_speeches/press/2001/press_113_01.cfm.

In terms of recognising and dealing with this emerging problem, the report noted that in June 1998 the regulator (HM Treasury) wrote to the appointed actuaries of all life offices with a questionnaire about annuity guarantees. The context for the questionnaire was stated in the following observation contained in the covering letter sent out with it: “given the trends in recent years in both pensioner mortality and market interest rates, we are conscious that a number of these guarantees may be of increasing significance to the financial management of individual life insurers”.

On the theme of the regulator’s involvement, in Chapter 17 of his Report, Lord Penrose goes into detail about the extent of the dealings between the regulatory bodies and Equitable Life, as also does Baird in his Chapter 4. I will not comment further on these matters here, but only to note that the evidence contained within these Reports indicates that the regulatory bodies only took an active interest in GARs from the middle of 1998 onwards, and that HM Treasury questioned Equitable Life about its justification for the differential terminal bonus policy in September 1998.

Turning now to the extent of the firm’s knowledge, the Penrose Report also refers in Chapter 1 to an internal paper dated 27 March 1998 prepared by a Mr Matthews (the assistant general manager responsible for running the actuarial projects department at Equitable Life) for an internal meeting held on 2 April 1998. One of the items for discussion in Mr Matthews’ paper was Equitable Life’s “*stance, when challenged on its treatment of annuity guarantee policyholders*”.

This therefore raises the question of when Equitable Life was first seriously challenged on this stance. Evidence on this was presented at last year’s court case by Equitable Life against fifteen ex-directors and Ernst & Young. These proceedings subsequently settled with no finding being made by the judge and therefore some of the evidence was not completely tested in the proceedings. It is noted, mostly from pages 203-205 of the opening submissions for Mr Wilson, one of the defendant ex-directors, that Equitable Life had received a single GAR-related complaint in each of the following months: January, February and March 1994, October 1995, June 1996 and November 1997. It is noted that these six complaints were largely resolved on an individual basis by the firm and that the PIA Ombudsman (one of the predecessor schemes to the Financial Ombudsman Service) did not receive any complaints on the GAR issue until July 1998.

In view of the above, it is clear that prior to the date that the sale to Mr H was made there was at least some understanding that the position in relation to GARs was a matter for debate; and some parties have pointed this Service to earlier matters that might now be seen as earlier indicators of the scope of the GAR risk - such matters including the decision taken by Equitable Life in 1983 to adapt terminal bonuses should market interest rates fall for a sustained period in future, and the firm’s decision in 1988 to issue new personal pension contracts without GARs.

When Ms E was advised to invest in the with-profits fund we concluded that Equitable Life had already been advised by its legal advisers of the GAR related risks. By the time Mr G was advised in March 1998, it would seem that the firm had at least identified the GAR risk internally and had started to deal with the emerging issue and there was also a growing body of complaints from customers about the use of the DTBP.

Prior to March 1998 however the evidence is more ambivalent. The firm had responded to some individual queries about the matter and was engaged in some wider professional discussion pre-March 1998. However it seems to me that these indicators fall short of a knowledge of material risk and might better be described as part of the growing understanding by the firm of the issue.

Overall, it seems to me that this does not prove that Equitable's senior management knew or ought to have known of the GAR related risk and its implications for non-GAR policyholders such as Mr H.

Where significant problems subsequently emerge hindsight has particular dangers. In assessing risk an actuary may well properly consider a multitude of issues that might impact the fund in future. These might best be considered theoretical risks and possible outcomes, not clear and agreed probabilities. Hindsight provides false clarity that can tie too rapidly those early thoughts to finally formed material risk assessments. What at the time may be seen as just one amongst many straws in the wind, may be seen in hindsight as the clearest possible signposting of a risk that has occurred.

It is simply not possible for a firm to set out all those possibilities in its advice to its customers. It must use its professional judgement to identify those matters that it reasonably considers material at that time.

In consequence, I conclude that it was not until March 1998 that Equitable Life was in breach of its duty of care (and its regulatory duty) in not referring to this risk when giving advice to invest in its with-profits fund.

In addition, I have also considered whether the advice given to Mr H was suitable, taking into account his circumstances and requirements at the point of sale. Having done so, and bearing in mind my conclusion that at this point Equitable did not know nor ought they have known of the materiality of the GAR related risk, I am satisfied that the advice was suitable in this respect, as Mr H's investment into the with-profits fund was suitable for somebody with a "cautious" or "low" attitude to risk at the time, as I believe that Mr H had. I am also satisfied that in all other respects the product was suitable for Mr H's needs and circumstances at the time.

A colleague of mine replied on 8 February 2005 to Mr H's further complaint about the statement in [the representative's] letter of 11 November 1997, and I agree with his reasoning as to why in the particular circumstances that complaint should fail. In essence, in order for me to uphold the complaint in this respect, I would need to be persuaded that there was a false statement of fact and that it had induced the contract. In this case, I agree with my colleague that whilst the description of the personal pension plan by [the representative] in his letter in November 1997 was not entirely accurate, that in itself did not induce Mr H to enter into the personal pension plan, as Mr H had already decided that he required such an investment vehicle and would have proceeded anyway in this respect.

Conclusion

Accordingly I conclude that Equitable Life did not breach any relevant law or regulatory duty when it advised Mr H in January 1998 to invest in the firm’s with-profits fund and did not mention the presence of the GAR-related risk.

Furthermore, I am satisfied that the investment advice was suitable for Mr H’s needs and circumstances at the time and that he did not enter into the contract on the basis of any misrepresentation. On that basis I reject the complaint made by Mr H against Equitable Life.

I now invite both parties to respond to my adjudication set out above within the next 28 days. If either side would like more time to reply, please let me know with reasons. I will consider any further evidence or arguments made by both parties and, if either side does not accept my adjudication outlined above, I will then refer this matter to an Ombudsman for a Final Decision.