

IN THE HIGH COURT OF JUSTICE
CHANCERY DIVISION
COMPANIES COURT



No. 6352 of 2007

IN THE MATTER OF THE EQUITABLE LIFE ASSURANCE SOCIETY
AND IN THE MATTER OF THE PRUDENTIAL ASSURANCE COMPANY LIMITED
AND IN THE MATTER OF THE FINANCIAL SERVICES AND MARKETS ACT 2000
AND IN THE MATTER OF A TRANSFER OF INSURANCE BUSINESS BETWEEN THE
EQUITABLE LIFE ASSURANCE SOCIETY (Transferor) and THE PRUDENTIAL ASSURANCE
COMPANY LIMITED (Transferee)

REPORT OF THE FINANCIAL SERVICES AUTHORITY

Summary

1. This report is made in order to provide the Court with information on the position of the Financial Services Authority ("**the FSA**") in relation to the application made by The Equitable Life Assurance Society ("**ELAS**") and The Prudential Assurance Company Limited ("**PAC**"), pursuant to section 107 of the Financial Services and Markets Act 2000 ("**FSMA 2000**"), to sanction an insurance business transfer scheme ("**the Scheme**").
2. The Scheme relates to insurance business carried on in the United Kingdom by ELAS, to be transferred to PAC.
3. The transferor, ELAS, is a mutual company, authorised by the FSA with permissions to effect and carry on long-term insurance business in classes I – IV, VI, and VII of Part II of Schedule 1 of the Financial Services and Markets Act 2000 (Regulatory Activities Order) 2001 ("**RAO**").
4. Prior to its closure to new business in December 2000, ELAS had offered a full range of savings, protection and pension policies, both non-profit and with-profits. On 8 December

2000, following a House of Lords¹ ruling that ELAS's differential bonus approach to guaranteed annuities on with-profits pension policies was unlawful, ELAS closed to new business. Since then all new annuities (other than a small number of overseas policies) written on the vesting of ELAS pension policies have been non-profit annuities.

5. Following the transfer of its non-profit annuity business to Canada Life in February 2007 the business of ELAS consists primarily of with-profits annuities and with-profits pensions (accumulating with-profits) business. For both categories of business, policyholders may be in possession of a guaranteed investment return ("**GIR**"). As explained in more detail at paragraphs 2.22 – 2.38 of the Independent Expert's Report, policies issued by ELAS before 01 July 1996 have a GIR of 3.5% per annum and policies issued after this date have a GIR of 0% per annum.
6. The operating assets and the economic interest in much of ELAS's non-profit business were sold to Halifax Bank of Scotland (**HBOS**) in February 2001. From March 2001 ELAS continued as an independent company with services provided under contract by HBOS.
7. The transferee, PAC, is a United Kingdom insurance company, authorised by the FSA to effect and carry on long-term insurance business in classes I-IV, VI and VII and short-term insurance business in classes 1 - 18. PAC's principal activity is long-term insurance business which consists of life and annuity, pensions, permanent health, and linked long-term business, which is carried on in the Ordinary Branch.² The company's long-term business includes conventional with-profits, accumulating with-profits, non-linked non-profit, and linked business. PAC's Industrial Branch³ was closed to new business on 1 January 1995.
8. PAC is a proprietary company, the shares of which are wholly owned by its immediate parent company, Prudential plc. PAC's long-term fund is divided into four sub-funds:
 - I. The With-Profits Sub Fund;
 - II. The Scottish Amicable Insurance Fund;
 - III. Defined Charges Participating Sub Fund;

¹ Equitable Life Assurance Society v Hyman [2002] 1 AC 408

² Ordinary Branch is the term used to describe a class of insurance business with premiums collected by a means other than door to door by agents (representatives) of the insurance company.

³ Industrial Branch is the term used to describe a class of insurance business with premiums collected door to door by agents (representatives) of the insurance company.

IV. Non-Profit Sub Fund

9. The FSA is of the opinion that in assessing the merits of the Scheme it is necessary to consider three groups of policyholders – the transferring policyholders ("**Transferring policyholders**"), the remaining policyholders in ELAS ("**Remaining policyholders**"), and the existing policyholders of PAC ("**PAC policyholders**").
10. The Scheme concerns approximately 66,000 contracts of long-term insurance business and affects approximately 53,000 Transferring policyholders. The date on which the Scheme takes effect (the "**Effective date**") is expected to be 31st December 2007. On the Effective date, the Scheme will have the effect of transferring the policies ("**the Transferring policies**") and the assets held by ELAS in respect of its with-profits annuities (including a proportionate share of the excess realistic assets), together with the liabilities in respect of this business, to PAC.
11. The FSA makes this report in its capacity as regulator of both ELAS as the transferor and PAC as the transferee. This report is provided to assist the Court in its evaluation of the Scheme and reflects the collective work of different divisions of the FSA. The divisions involved in the FSA's consideration of this transfer include:
 - a) Regulatory Transactions Division;
 - b) Retail Firms Division (Supervision);
 - c) Retail Firms Division (Life Actuaries); and
 - d) General Counsel's Division.
12. The FSA is entitled to be heard by the Court on this application pursuant to section 110 FSMA 2000.
13. The FSA does not object to the Scheme. The FSA proposes to appear by Counsel at the hearing of the application for an order sanctioning the Scheme listed on 28th November 2007.

General background issues relevant to the Scheme

14. The FSA's general approach to the evaluation of schemes is set out in **Annex I** to this report.

Scheme Report

15. Mr Steve Sarjant ("**the Independent Expert**"), a consulting actuary of the actuarial consultancy, Watson Wyatt Limited, was appointed by ELAS and PAC to prepare a report ("**the Scheme Report**") on the terms of the Scheme as is required for Part VII transfers pursuant to section 109(1) FSMA 2000.
16. On 1 August 2007, the FSA approved the appointment of the Independent Expert pursuant to section 109(2) FSMA 2000. The FSA's approval was unconditional. A copy of the FSA's letter dated 1 August 2007 is attached at **Annex IV**.
17. On 30 August 2007, the FSA approved the form of the Scheme Report pursuant to section 109(3) FSMA 2000. A copy of the FSA's letter dated 30 August 2007 is attached at **Annex IV**.
18. In making this report, the FSA relied (where indicated) on the Scheme Report, a copy of which is attached at **Annex IV**.

Certificates

19. Details of the certificates obtained by the FSA are set out at **Annex II**.
20. The Certificate as to Margin of Solvency is attached at **Annex IV**.
21. The Certificate of Consent to transfers of long-term insurance business (other than reinsurance) in which an EEA state other than the United Kingdom is the member state of the commitment is attached at **Annex IV**.

Notification of policyholders and affected persons

22. The FSA is of the opinion that policyholders and affected persons have received sufficient information about the Scheme, as required by FSMA 2000. Details of the FSA's evaluation are set out in **Annex III**.

Background issues relevant to the FSA's evaluation of this Scheme

23. As part of its normal supervision of the insurance businesses of both ELAS and PAC the FSA has considered the Scheme as it developed. The FSA's consideration of the Scheme has been based on specific information requested from both ELAS and PAC as necessary, and on its wider knowledge of and assessment of ELAS and PAC acquired in the course of the FSA's supervision of both ELAS and PAC.
24. This transfer follows the completion of the transfer of the bulk of ELAS's non-profit pension annuity business, comprising approximately £4.6 billion, to Canada Life Limited on 9th February 2007.
25. The transfer of the with-profits annuities policies to PAC will simplify ELAS's with-profits business, making it a more standard business to manage in a closed-fund environment and pave the way for strategic approaches to be developed for the Remaining with-profits policyholders going forward (as described in the Policyholder Circular in Part IV, section 2.2 on page 26 appended at **Annex IV** to this report.).

*The Parliamentary and Health and Services Ombudsman Enquiry ("**Parliamentary Ombudsman**")*

26. The Independent Expert refers to the investigation at paragraph 7.86 of his report where he says:

"There is currently an ongoing investigation by the Parliamentary Ombudsman into the conduct of the former regulators of ELAS. The European Parliament has also reported on the regulation of ELAS. I understand that some holders of Transferring Policies might be concerned that, should the publication of these reports lead to compensation being payable to ELAS policyholders by the British Government, they might forego any entitlement to receive such compensation as a result of the Transfer of their policies from ELAS to PAC. It is outside my area of expertise to comment on the likelihood of there being any such compensation payable, the basis on which any such compensation would be paid and hence on whether the implementation of the Scheme could impact on the interests of holders of Transferring Policies in this respect".

27. If the Government were to pay compensation to ELAS policyholders, the form, amount and recipients of such payments would be a matter for the Government. The FSA would liaise with the Government and ELAS with a view to ensuring that all ELAS policyholders are treated fairly.
28. Section 7(2) of the Parliamentary Commissioner Act 1967 requires that any investigation conducted by the Parliamentary Ombudsman be conducted in private. Section 11(2)(a) of the same Act prevents disclosure of any information obtained by the Parliamentary Ombudsman during any investigation that she conducts other than through her final report or for the purposes of the investigation. The FSA is therefore not able to disclose details about the way in which the investigation is being conducted or any information that the Parliamentary Ombudsman may be considering.
29. In her last letter to Members of Parliament of 22 May 2007, reporting on the progress her investigation had made, the Parliamentary Ombudsman said that "I can give no commitment as to the timetable for publication". The FSA has seen a copy of the report in draft in strict confidence and has had an opportunity to comment on it. It is for the Parliamentary Ombudsman to decide who should see information during the course of an investigation, so it has not been possible for the FSA to share the full draft report with ELAS in advance of preparing this report, although the FSA understands that the FSA, those representing the complainants and ELAS, will all be offered the opportunity to see and comment on a further draft in due course, again subject to strict confidentiality. Therefore, publication is still some time away. The Parliamentary Ombudsman's concluded view as to whether there was maladministration on the part of those responsible for the prudential regulation of ELAS, and whether that in turn caused injustice to those who have complained to her, will only be set out in the report that is published.
30. The Parliamentary Ombudsman's investigation is concerned with the prudential regulation of ELAS in the period prior to 1 December 2001, not with ELAS's conduct. The Parliamentary Ombudsman has no power to make adverse findings in respect of ELAS. Her investigation is also not concerned with the regulation of the manner in which ELAS dealt with its customers.
31. Despite this, the FSA has considered what the effects might be on ELAS if, as a result of information contained within the Parliamentary Ombudsman's report, ELAS were exposed to fresh claims and the Scheme had been implemented in the meantime. The FSA carried out a similar exercise following the publication of the report by Lord Penrose in March 2004.

32. In the absence of the Scheme, any such claims arising would fall on the with-profits fund and would thus impact on the benefits of all with-profits policyholders, including both those with Transferring Policies and those with policies remaining at ELAS ("**Remaining Policies**"). Were the Scheme to be implemented, any such claims would again fall on ELAS's with-profits fund, but in this instance they would impact only on the benefits of those with Remaining Policies.
33. Therefore, if claims might arise, and if the Scheme went ahead without any allowance for them, policyholders with Remaining Policies would be exposed to the risk of having their benefits reduced as a result of factors which would otherwise have fallen partially on Transferring Policies.
34. Until the Parliamentary Ombudsman publishes her report in its final form it is not possible for the FSA comprehensively to consider whether ELAS is likely to be subject to further claims. However, given the risk referred to above, neither is it appropriate for the FSA not to consider this matter at all.
35. Consequently, the approach which the FSA has taken is as follows. It has considered a range of scenarios which might arise from publication of the Parliamentary Ombudsman's report, including that it is published in the form in which the FSA has received it in draft. Having done this, the FSA has also considered whether the possibility of additional claims against ELAS can be ruled out in each of these scenarios. The FSA has also taken advice from leading counsel on the same question.
36. The FSA's conclusion is that the probability of substantial additional claims arising and succeeding is remote, but that such claims cannot entirely be ruled out.
37. The FSA next considered what the possible quantum of these claims might be and what provision or allowance should be made for them, having regard to the likelihood of the claims being made and succeeding. The FSA took independent actuarial advice on these questions. The purpose was to assess whether it would be unfair to any material extent if the Scheme went ahead without any provision or allowance being made for such claims.
38. As presented to the court, the Scheme does not make an express allowance for these possible claims. The FSA has engaged in extensive discussions with ELAS about this and, as far as the FSA is able, given the confidentiality constraints, it has shared its legal and actuarial advice with ELAS. The FSA has throughout recognised that, were claims to materialise, they

might be for substantial amounts (when legal and experts' costs are included) but also that it is unlikely that any such claims will in fact be made and still less likely that they would succeed. Having regard to all the circumstances, the FSA has concluded that, while the risk should not be disregarded, only a very modest allowance is necessary and justified in relation to this risk.

39. The financial statements for ELAS circulated to policyholders in September include a number of allowances for uncertain and contingent events. ELAS has agreed to make a small adjustment to these allowances in case such claims (as outlined above) materialise. This adjustment leads to a proportionate reduction in the benefit expectations of those with Transferring Policies. However, this reduction is immaterial in relation to the overall assets associated with Transferring Policies (some £1.9bn).
40. Accordingly, taking into account the need for the Scheme to be fair to both groups of policyholders, and the difficulty of trying to quantify the risk of the claims described above being made, the FSA does not consider that the treatment for them now adopted by ELAS is unfair nor that it should cause the FSA to object to the Scheme.

Significant regulatory issues raised by the Scheme

The impact of the Scheme on the Remaining policyholders

41. The FSA believes that there are no significant regulatory issues raised by the Scheme in respect of the Remaining policyholders after the effective date.
42. The Independent Expert concludes at paragraph 8.17 of the Scheme Report that the reasonable benefit expectations and the security of guaranteed benefits of the Remaining policyholders will remain at an acceptable level following implementation of the Scheme.
43. The FSA agrees with the conclusions of the Independent Expert in this regard. Further, the FSA's supervisory activities (which include a review of ELAS's individual capital assessment and a review of ELAS's published annual insurance return for the year-ended 2006 and the half-year return for the period to 30 June 2007), support the Independent Expert's view that ELAS has sufficient financial strength to provide adequately for the Remaining policyholders following implementation of the Scheme.

The impact of the Scheme on PAC policyholders

44. The Independent Expert concludes at paragraph 9.23 of the Scheme Report that there will be no adverse impact of the Scheme on the reasonable benefit expectations of PAC policyholders, and that the security of guaranteed benefits of existing PAC policyholders will not be materially affected by the Scheme.
45. The FSA agrees with the conclusions of the Independent Expert in this regard. Further, the FSA's supervisory activities (which include a review of PAC's individual capital assessment and a review of PAC's published annual insurance return for the year-ended 2006 and the half-year return for the period to 30 June 2007), support the Independent Expert's view that PAC has sufficient financial strength to provide adequately for the current PAC policyholders following implementation of the Scheme.

The impact of the Scheme on the Transferring policyholders

46. The FSA considers there are a number of positive features of the Scheme that benefit Transferring policyholders, such as the potential for higher investment returns from PAC's with-profits fund than from ELAS's with-profits fund, the cap of 1% p.a. on the charges made to Transferring policyholders for expenses, the mortality cap and collar arrangement, and the guarantees provided by PAC.
47. The benefits outlined in paragraph 46 above reflect the fact that the Transferring policyholders are transferring to one of the largest with-profits funds in the UK, which continues to be a well capitalised fund. As at 31 December 2006 PAC had an excess of assets over liabilities of £27.6 billion on the 'regulatory peak' measure used in their end-2006 FSA returns, representing 36% of its liabilities, which is a measure of its ability to meet guaranteed liabilities. ELAS, in comparison, had a corresponding excess of £1.0 billion (adjusted for certain post balance sheet events), which represented only 11% of its liabilities.
48. The FSA believes that a key consideration for a significant majority of Transferring policyholders will be the potential for higher investment returns generated by a fund with a greater proportion of equities and properties than the ELAS fund. As noted above, Transferring policyholders will be exposed to a significantly higher investment in equities and properties than would have been the case had they remained in ELAS.
49. The FSA has considered the analysis conducted by ELAS, and concludes that reasonable assumptions were made with respect to the discount rate, the equity risk premium (i.e. the difference between the rate of return on real assets and the rate of return on fixed interest

investments) and other variables. The overall conclusion of the Independent Expert is summarised at paragraph 7.72 of his report (last bullet point) and the FSA agrees with the conclusion of the Independent Expert as set out in that paragraph.

50. In summary, although there are some circumstances in which Transferring policyholders could be worse off, there is a wide range of likely circumstances where Transferring policyholders would be no worse off. Further, the potential downside is limited by the fact that the guarantees under the policies will remain as before, and will not be altered by the Scheme. Moreover, the potential upside is unlimited.
51. A further consideration is that there are other features of the Scheme that are beneficial to Transferring policyholders, as outlined in paragraph 46 above, which policyholders might consider to be valuable, even if bonuses on non-guaranteed benefits turn out to be the same as those that might have been payable had they remained with ELAS.
52. Overall, therefore, the FSA has no reason to doubt the conclusion of the Independent Expert to the effect that, considering the portfolio of Transferring Policies as a whole, the reasonable benefit expectations of the holders of Transferring Policies in aggregate will not be adversely affected by the Scheme, despite the fact that there are some circumstances in which Transferring policyholders could be worse off as a result of the transfer.
53. There are a few matters relating to the costs of the Scheme (fully explained in section 4 of the Independent Expert's report) that may affect Transferring policyholders as set out below in paragraphs 54 to 68.
54. There is no premium or fee payable by ELAS to PAC in order to secure the benefits underwritten in PAC. There are, however, the costs of the Scheme itself together with some indirect costs incurred by Transferring policyholders, reflected in the Scheme through a reduction (by way of charges and adjustments) to both the Transferring policyholders' and the Remaining policyholders' shares of ELAS's working capital.
55. The FSA's assessment of the costs of the Scheme focused on the fairness of the charges taken from, and adjustments to, excess realistic assets (working capital), and whether they are of such magnitude that with-profits annuitants (Transferring policyholders) might be better off remaining with ELAS, thereby potentially sharing, over time, the working capital attributable to them. The FSA has reviewed the fairness of what it considers to be the most significant charges and adjustments to working capital, as follows:

a) *The upfront guarantee charge*

56. The benefits under ELAS with-profits annuities are guaranteed not to reduce below the amounts set out in the policies. Because the assets attributable to these annuities will fluctuate in value over the course of time, and their value may, on occasion, be less than the value of the guaranteed benefits promised under the policies, there is a potential cost to the company of honouring these guarantees. In common with industry practice, part of this cost in respect of the with-profits annuity business is recharged to the Transferring policyholders. This cost is greater the more the fund invests in real assets (equities and properties), which are more volatile than gilts and bonds.
57. Accordingly, if the policies transfer to PAC under the Scheme the cost of these guarantees will increase due to 68% of the PAC fund being invested in real assets, compared with 17% at ELAS.
58. The result is a one-off charge of £43.5 million as at 31/12/06 (because of the higher equity backing ratio ("**EBR**") in the PAC with-profits sub fund) to the Transferring policyholders paid from their allocation of the working capital. The methodology for the calculation of this charge is described in paragraphs 4.41 to 4.48 of the Independent Expert's Report. The FSA believes the methodology to be a fair and reasonable one.

b) *The mortality risk cap and collar charge*

59. Holders of Transferring Policies are currently exposed to mortality risk. All life insurance companies make assumptions about future improvements in life expectancy in managing annuity business and reserve accordingly in order to meet expected future income payments.
60. However, if those assumptions turn out to be insufficiently conservative, then excess realistic assets (working capital) will reduce and ultimately, in the case of with-profits annuities, annuity income may be lower than it otherwise would have been.
61. This mortality risk is currently shared by all with-profits policyholders in ELAS. Upon transfer to PAC, assuming no other action is taken, all of this mortality risk will be borne by the Transferring policyholders. This means that should the longevity of the Transferring policyholders turn out to be greater than is currently anticipated in the relevant assumptions, the amount of their annuity income (ignoring the effect of guarantees) would need to be

restricted so as to ensure that the funds transferred to PAC under the Scheme are not exhausted until the death of the last annuitant.

62. ELAS has elected to insure against the risk of more permanent fluctuations of mortality in the relevant PAC fund having the effect of increasing or reducing the amount of the annuitants' income by more than 0.5% per annum. For this, ELAS is paying a premium of £17 million to PAC, the Transferring policyholders' share of this being about £4 million (representing 23% of the premium and reflecting the exposed to risk proportion of the Transferring and Remaining policyholders). The methodology for the calculation of the mortality premium is described in paragraph 4.34 of the Independent Expert's Report. The FSA believes the methodology to be a fair and reasonable one.

c) The diseconomies of scale charge

63. ELAS makes a deduction of 1% per annum from all Policy Values (which are ELAS's equivalent to asset shares) for expenses and tax. Following a review in 2006 the Board decided that it would maintain the deduction at this level.
64. In determining the realistic balance sheet, ELAS compares the present value of future expenses on a best-estimate basis, with the present value of these future expense deductions. To the extent that there is a shortfall, a provision is established. This expense overrun provision amounted to £60 million on ELAS's realistic balance sheet at 31st December 2006.
65. The effect of the Scheme will be to increase the size of the expense overrun provision needed because the reduction in the present value of future expenses incurred by ELAS will be less than the reduction in the present value of the future expense charge received. This reflects the fact that: (i) a proportion of ELAS's expenses do not vary directly with the policies in force, and (ii) the Transferring Policies, being of large average size, contribute proportionally more expense margins than do the Remaining Policies.
66. Therefore, it is intended to reduce the allocation of working capital to the Transferring Policies by an amount reflecting the increase in the expense overrun provision needed for the Remaining policyholders at the date of transfer (31 December 2007). This amount has been calculated as £89 million, and assumes the orderly run-off of the Remaining Policies over a prolonged period of time and the continuation of HBOS as third-party administrators.

67. The FSA believes it is fair and reasonable to make an adjustment for the diseconomies of scale effect of the transfer, and has no reason to believe that ELAS has calculated the adjustment on anything other than a fair basis.

d) *Overall effect of charges and adjustments to working capital:*

68. In total the Transferring policyholders' share of these charges and adjustments amount to around £136 million. In the FSA's opinion it is reasonable for these charges and adjustments to be levied and, whilst there is more than one basis on which they could have been calculated and attributed to Transferring and Remaining policyholders, the bases on which they have been calculated and attributed are, in the opinion of the FSA, fair and reasonable.

The weighing up of factors impacting on the Transferring policyholders

69. The Scheme is relatively complex in its structure and, consequently, it has not been a simple task for the FSA to determine whether prospective Transferring policyholders would be at least as well off under it as if they were to remain with ELAS. Transferring policyholders will benefit from the possible investment out-performance arising from being invested in a fund with an equity backing ratio of 68% (compared to the current 17% in ELAS), together with the improved security that comes from being part of a financially stronger insurer and the other benefits provided by the Scheme. For this, they bear the risks and the costs arising from the Scheme.

70. The risk that Transferring policyholders bear is the volatility associated with investing in equities (the fact that the values of equities could fall as well as rise resulting in the possibility of bonuses not being paid by PAC in some years), and the cost is the reduction in working capital (arising from a number of charges and adjustments, as described in paragraphs 56 to 68 above) which might otherwise have been distributable to Transferring policyholders (all other things being equal) over time.

71. In this regard it is helpful to consider (as set out in the Scheme Report at paragraphs 7.52, 7.53 and 7.72, page 68) that had the Scheme been implemented on 31 December 2006, the costs and adjustments would have resulted in a reduction in working capital equivalent to about 8% of transferring policy values (about £150 million). There is, of course, no guarantee that this 8% would have been distributed over time to Transferring policyholders, as circumstances and conditions could change in the future causing the value of working capital to fluctuate and / or be retained to support the business. A reduction in working capital of

£150 million would have left sufficient working capital to enable PAC to declare a relatively modest bonus on non-guaranteed benefits had the Scheme been implemented on 31 December 2006. This would have been declared about 6 -9 months after the Scheme effective date.

72. On balance, the FSA believes the Scheme is fair to Transferring policyholders. Their guaranteed benefits remain as before, and in all probability are strengthened by the transfer (as a consequence of PAC's greater financial strength and resources). Furthermore, Transferring policyholders have improved prospects of receiving increases in their non-guaranteed benefits because of the higher EBR in the PAC with-profits sub-fund, although these benefits will be subject to greater volatility (with some protection offered through a smoothing account).

Significant issues of policyholder communication and understanding

73. The purpose of the communications by ELAS and PAC in this transfer was twofold:
- i. Information required under the FSMA Part VII procedure;
 - ii. Information provided to members of ELAS, who under ELAS's Articles of Association Section III (7) are required to approve the proposed transfer at an Extraordinary General Meeting (EGM).

(i) Communication under the Part VII procedure:

74. Three hundred and forty three policyholders were not sent copies of the Scheme documents until 15 October 2007.
75. The FSA understands that the delay was caused by the poor print quality of the documents which led to them being withheld in order that they be reprinted and sent out later; due to accidental oversight they were not sent out until the later date, details of which are set out in the third witness statement of Julie Houston at paragraph 19.
76. The FSA also understands that the relevant policyholders are overseas policyholders and would not have received the Scheme documents until on or about 20 October 2007.
77. The FSA guidance (SUP 18.2.46G of the FSA Handbook refers) suggests that policyholders should have a minimum of six weeks between the sending of the notices to policyholders and

the date of the final hearing to consider such documents. In this instance, the policyholders may have had less than six weeks to consider the information.

78. However, the six week period is only a guide, and the FSA considers that, taking account of the costs and other implications associated with a possible postponement of the Final Court hearing, it would be disproportionate to object to the Scheme, given that:
- i. only a very small percentage of policyholders (343 out of 53,000 Transferring policyholders) received a reduced notification period
 - ii. the advertising carried out by ELAS and the transferee was substantially more wide-ranging than would have been carried out in the usual course.
79. In the circumstances, the FSA does not intend to object to the transfer on the ground of reduced notification.

(ii) Communication to members prior to the vote,

80. Communication packs were sent to members of ELAS on 28 September 2007, giving members just under 4 weeks' notice of the EGM held on 26 October 2007 and as part of the FSA's general regulatory duties⁴ the FSA reviewed the communication pack and concluded that the information was clear, fair and not misleading. The FSA was informed by ELAS that at the EGM an overwhelming majority (98%) of those members voting (either in person, or by the chairman's proxy vote) voted in favour of the Scheme.
81. The FSA considered the communication pack information and the concern raised by several policyholders that the member vote on the Scheme should not take place until after the FSA had filed this Report to the Court.
82. The FSA considers that the process for the proposed Scheme to be put to all members of ELAS at EGM is a matter for the relationship between ELAS and its members who own it, as set out in ELAS's Articles of Association. The FSA would only exceptionally become involved in this process, for example in circumstances where an authorised firm had clearly failed to follow the procedures set out in the articles. This was not the case here.

⁴ This includes Principles 6 and 7 in the FSA's Handbook of rules and guidance, Principles for Business.

The FSA's Decision

83. Based on the information provided by all relevant parties, the views of the Independent Expert, Actuarial Function Holders, With-Profits Actuaries and the considerations set out in this report, the FSA is satisfied that the Scheme is within the range of reasonable and fair schemes available to ELAS and PAC. Accordingly, the FSA does not object to the Scheme.

Objections and Representations Received and Considered by the FSA

84. The notice to ELAS policyholders and other affected persons requested that representations in writing and written indications of proposed submissions to the court should be sent to Lovells, the representatives acting on behalf of ELAS, by not later than 25th November 2007. In addition both ELAS and PAC have notified policyholders and other affected persons, by way of prominent notices posted on their websites. The notices on the websites also explain that representations can be made directly to the FSA.
85. As at the date of this report, the FSA has received 10 representations directly. One of the representations, comprising 3 letters, was received from Mr Newman (Chairman of the Equitable Members Action Group, "EMAG"). The FSA, at the request of EMAG, met representatives of EMAG on 11 October 2007 to hear their concerns. The FSA understands that EMAG (represented by Mr Newman) intends to appear by Counsel at the hearing of the application for an order sanctioning the Scheme, and will be preparing a Witness Statement for the Court.
86. Lovells has sent the FSA, and the FSA has reviewed, copies of 13 representations received by ELAS, 2 representations (one of which comprises 3 letters from Mr Newman) received by the Independent Expert, and 1 representation received by Lovells (and copied to the Court) in connection with the Scheme. The FSA has also reviewed copies of the responses to those representations.
87. The material issues raised and the FSA's view of each of them are summarised in paragraphs 88 to 116 below.

The fairness of the transaction

88. A number of ELAS policyholders have written to the FSA urging it to ensure that the transaction is fair to all policyholders, particularly in relation to the attribution of the costs of

the transaction between Transferring and Remaining policyholders, and that the level of assets remaining in ELAS is sufficient to cover the residual liabilities.

89. The FSA is satisfied that the transaction is fair to the generality of all policyholders (the Remaining ELAS, Transferring ELAS and PAC policyholders), that the costs of the transaction have been fairly attributed to Transferring and Remaining policyholders, and that the methodology for calculating the value of assets transferred and remaining is a fair one.

The timing of the policyholder vote and the filing of the FSA's Report to the Court

90. A number of ELAS policyholders have asserted that it is unfair that they should be asked to vote on the proposed Scheme in advance of FSA filing this Report to the Court.
91. As set out above, the FSA is of the view that the policyholder vote is a matter for the arrangements governing the relationship between ELAS and the members who own it, as set out in its Articles of Association. ELAS maintains that it has followed the procedures as set out in its Articles of Association.
92. The FSA's Report to the Court is the product of a review process to ensure that what has been proposed is consistent with the FSA's statutory objectives under FSMA 2000, and is fair to the generality of policyholders, not just of ELAS but also of PAC.
93. The FSA has filed its report with the Court 6 days before the final court hearing, and policyholders are able to attend the final court hearing to raise any final concerns which they may have about the transfer.

The operation of the smoothing account from the date of transfer

94. Some Transferring policyholders have been concerned that because the smoothing account, in the PAC sub-fund to which with-profits annuity policyholders will be transferred, starts-off with an initial value of zero, this means that (1) the benefits of smoothing will only apply in the short term, and that (2) smoothing (within normal bounds – 0% to 11%) will not necessarily apply in the event of an extreme scenario (such as a severe downturn in the equity markets).
95. Smoothing relates to the extent to which the company "rides out" the normal peaks and troughs of the market and pays out more or less than is supported by the value of the

underlying assets. Over time the intention under the Scheme is that the effect of this smoothing will be cost neutral, i.e. that it is managed with the aim that it should tend to zero.

96. With respect to the first concern - that the benefits of smoothing will only apply in the short term - the FSA is satisfied that the Scheme provides a smoothing benefit to Transferring policyholders over both the short and long term as described in paragraphs 7.68 to 7.71 of the Independent Expert's Report.
97. With respect to the second concern - that smoothing (within normal bounds – 0% to 11%) will not necessarily apply in the event of an extreme scenario – it is true that smoothing within normal bounds will not apply in the most adverse of circumstances, but as the Independent Expert explains in paragraph 7.71 of his Report, "it is common practice when managing with-profits business to permit smoothing outside of normal bounds in exceptional circumstances in order to protect other with-profits policies and I therefore believe that the inclusion of these provisions in the Scheme is reasonable".
98. The FSA agrees with this statement, and furthermore, notes that there are no explicit smoothing arrangements currently in ELAS.

The risks associated with investment in a fund with a higher EBR following transfer to PAC.

99. A small number of ELAS policyholders have expressed concern that they may experience significant reductions in annuity income following transfer should there be a significant fall in the equity markets, and have expressed the desire to remain with ELAS, in a fund that has a greater fixed-interest asset content.
100. The FSA agrees that a fund with a higher EBR is more volatile than a fund with a greater exposure to fixed-interest assets, but is satisfied that the risk-reward balance has been adequately explained to policyholders, and that the asset mix in the target fund is more akin to the type of fund envisaged at the outset and still desired by a majority of the with-profits annuity policyholders (as evidenced by the overwhelming number of policyholders voting in favour of the Scheme at the EGM). Consequently, the FSA has no reason to object to this aspect of the Scheme.

The risks of a Scheme being implemented whilst complaints, business reviews and enquiries continue

101. A small number of ELAS policyholders have expressed the view that the Scheme should not proceed whilst ELAS continues to receive mis-selling complaints and has yet to complete a number of reviews of past business. ELAS is subject to close monitoring by the FSA (which includes the conduct and progress of business reviews and the handling of customer complaints). Whilst some reviews are not complete and complaints continue to be received, the FSA is of the view that this is not a reason to hold up the transfer of business under the Scheme.

The risks of a Scheme being implemented whilst the Parliamentary Ombudsman enquiry continues

102. A number of Transferring ELAS policyholders have expressed concern that if the Scheme is implemented whilst the enquiry of the Parliamentary Ombudsman is still ongoing they will not be entitled to receive any compensation that she may recommend and the Government agrees to pay to ELAS policyholders.
103. The FSA considers that if the Government were to agree to pay compensation to ELAS policyholders the form, amount, and recipients of such payments would be a matter for the Government. This includes whether or not former policyholders should participate in any compensation. Consequently, the FSA sees no reason to object to the proposed Scheme on the grounds that the enquiry of the Parliamentary Ombudsman continues.
104. The FSA's position in relation to the Parliamentary Ombudsman's enquiry is referred to at paragraphs 26 to 40 above.

Identification of classes of policyholders

105. Some ELAS policyholders have expressed the view that in assessing the merits of the Scheme it is necessary to make a distinction between those policyholders who are in possession of a guaranteed investment return ("**GIR**") of 3.5% and those with a GIR of 0%.
106. The Independent Expert's Report sets out at paragraph 7.72 a summary of the impact of the Scheme on the benefit expectations of the holders of Transferring policyholders. This paragraph of the Independent Expert's Report includes a description of the impact both on Transferring Policies with a GIR of 3.5% and on those with a GIR of 0%.
107. As the Independent Expert confirms in paragraph 7.72 (1st bullet point), the mechanism for determining the amount of the income payable under each with profits annuity is not altered

by the Scheme. The level of income payable under a Transferring Policy will be determined as the higher of the guaranteed and non-guaranteed income applicable to the policy. This is the current position in ELAS and will continue to be the position following the transfer to PAC.

108. The FSA is satisfied that adequate consideration has been given both to Transferring Policies with a GIR of 3.5% and to those with a GIR of 0%, and that there is nothing about the Scheme that requires these two groups to be differentiated further.

Charges for both Transferring and Remaining policyholders are excessive post-transfer

109. Mr Newman (EMAG chairman) has expressed concern that the level of ongoing charges payable by Transferring policyholders might be regarded as excessive. The FSA is of the view that the 1% charge levied by PAC for expenses incurred in administering the transferred business is fair, as it has been set at a level equivalent to that currently levied by ELAS, and is guaranteed by PAC not to increase.
110. Furthermore, the FSA agrees with the Independent Expert in his view that, compared to the uncertainty of future expense levels in a closed fund such as ELAS, there is a benefit in terms of certainty to Transferring policyholders of a fixed expense charge.
111. In addition to the upfront guarantee charge detailed in paragraph 58 above, a further charge of up to 0.5% per annum (as currently) is payable for the expected cost of the guarantees relating to the Transferring Policies. Given the nature of these guarantees, the FSA considers this charge to have been determined on a fair and commercial basis.
112. Mr Newman has also expressed concern that, following the transfer, the Remaining Policies will bear excessive charges from HBOS. Whilst the FSA believes the arrangements ELAS enters into with HBOS for administering its business constitute a commercial matter between HBOS and the Board of Directors of ELAS, the FSA is also of the opinion that adequate arrangements have been made to ensure Remaining policyholders are no worse-off once the Scheme has been implemented.
113. ELAS will continue to deduct 1% from policy values each year to cover the estimated charges that will be levied by HBOS. To the extent that the 1% does not cover the actual charges, ELAS has established an expense overrun provision which is anticipated to cover this shortfall over time. As a result of diseconomies of scale arising from this transfer, this

provision is to be increased by £89 million (this is the diseconomies of scale adjustment described in paragraphs 63 to 67 above).

114. Going forward, the agreement with HBOS expires in 2011. The FSA understands that ELAS is in negotiations with HBOS to reach agreement on administration arrangements after this date, and potentially before, if the contract with HBOS is terminated prematurely.

Uncertainty of future liabilities

115. Some ELAS policyholders have expressed a concern that any future liabilities will fall solely on the 77% of policyholders that will remain once the Scheme has been implemented, rather than the 100% at present.
116. This, of course, will be the case. However, the FSA has discussed with ELAS and its advisers, the nature and amount of known liabilities that remain, the nature of any contingent liabilities and uncertainties, and the various provisions that should be made for them. The FSA accepts that to the extent that these provisions are too low, then Transferring policyholders will benefit. On the other hand, to the extent that these provisions are too high then Transferring policyholders will lose-out, having contributed too much towards the provisions before leaving ELAS. However, on balance, and given the difficulty of quantifying uncertain future liabilities, the FSA considers that the treatment of these provisions adopted by ELAS is fair, and nothing in this provisioning exercise causes the FSA to object to the Scheme on this basis.



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Retail Firms Division – Head of Insurance Department

A duly authorised official of the Financial Services Authority

Dated the 22nd of November 2007