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Mr. Colin Tanner
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Dear Mr. Tanner,

Scottish Widows Demutualisation

Further to our telephone conversation before Christmas, I am responding to your request that I should put my concerns to you in writing. You will remember that I advised you to retain your recording of our telephone conversation.

1. As a result of the Equitable Life *débâcle*, which, as far as I can remember, resulted from a liability in the region of £1bn to some 90,000 Guaranteed Annuity Rate (GAR) policyholders, the directors of Lloyds TSB and Scottish Widows were aware, at the time of the Scottish Widows demutualisation, of a contingent liability amounting to some £1.5bn with respect to some 200,000 Scottish Widows GAR policyholders.
2. It is my view that the directors may have been motivated by this factor in the Scottish Widows demutualisation. I have no direct evidence of this and no such motivation is mentioned in the circulars sent to policyholders. Nonetheless, I believe that any reasonable person would find it hard to believe that it was not a significant factor given the potentially catastrophic consequences to Scottish Widows or, to put it another way, that they were 'running for cover'.
3. It is my view that the existence of this contingent liability was material in the context of the demutualisation and that the directors therefore had a duty to ensure that the matter was properly disclosed to policyholders and other parties, such as the Court that (as I understand it) approved the demutualisation, so that those parties could make a proper assessment of the situation and the Board's recommendation. The question is whether the matter was properly disclosed.
4. At one level the question of proper disclosure is a simple question of historical fact. At the relevant time, did the policyholders (or the Court) fully appreciate the nature and extent of the contingent liability on the basis of the circulars or other information made available to them? In order to assess this it is only necessary to ask them (that is, a representative sample of them). The comments that I have heard and my own reading of the circulars lead me to the view that they did not fully understand the nature of the contingent liability and it is my view therefore that the liability was not properly disclosed.
5. The question arises as to what constitutes 'proper disclosure'. I believe that we can be guided in this matter by the relevant FRS on contingent liabilities. Although this FRS is intended to apply to financial statements, I can see no good reason as to why it should

not be accepted as an appropriate standard in the context of the demutualisation. I believe you will find that the FRS defines contingent liabilities, specifies the circumstances in which they should be disclosed and the information to be disclosed. Basically, as I understand it, there is a fundamental distinction between a 'remote contingency' (where the likelihood of crystallisation is considered remote) and other types of contingencies. The FRS states that remote contingencies should not be disclosed at all; other contingencies should be disclosed. Where a contingent liability is disclosed, I believe that it is a requirement to disclose the nature and extent of the contingency (with the appropriate emphasis), together with an explanation of the circumstances in which it is considered that contingency might crystallise. My review of the demutualisation circulars sent to policyholders leads me to the view that the contingent liability was not properly disclosed in these terms - see in particular page 24 of the Policyholder Circular dated 19th November 1999.

6. In addition, the directors also set aside a provision of £1.5bn in the 'Additional Account', which happened to equal (roughly) the liability to GAR policyholders. In such circumstances the question will naturally occur to any reasonable person as to why this sum of £1.5bn was set aside in the first place? Was it based on sound historical precedent, sound business reasons and sound actuarial principles? The key point here is that in spite of the significance of the amount involved and the importance of explaining fully the reasons for setting aside this amount (regardless of any FRS), **no clear explanation was given** in the circulars sent to policyholders. There is an explanation of **what** (of a sort) but not **why** - see pages 23 and 33 of the Policyholder Circular dated 19th November 1999.
7. In my view it is also relevant that, as I understand it, other life companies had similar contingent liabilities at that time. It is my view that both the FSA and the auditors of these companies must have been aware of the situation, yet the FSA, as far as I am aware, took no action and I am not aware (even after the House of Lords decision in the Equitable Life case) of any set of accounts of any such company being qualified on this basis. I have seen the Scottish Widows demutualisation and the matter of the Additional Account referred to as 'the corporate scandal of the decade' but it occurs to me that the business may go a little further than that.
8. You will appreciate that I have not been able to carry out a full investigation into this matter and, indeed, that I do not have the authority to do so. The fact that I have recently been suspended from my job (as we discussed) is, in my view, designed to prevent me from obtaining further information. I believe that this has also been done in an attempt to discredit me and you should be prepared for every possible form of character assassination. Having said that, it is not my duty to carry out an investigation. My duty is to report that I have been put on enquiry to the appropriate parties, which I am now doing. It is your duty and the duty of the Audit Committee to ensure that the matter is fully investigated.
9. I am copying this letter to the Chairman of the Audit Committee and, in the public interest, to my M.P.

Yours sincerely,

Graham Milne