Financial Services Authority

FINAL NOTICE

To:	Scottish Equitable PLC
FSA Reference Number:	165548
Date:	15 December 2010

TAKE NOTICE: The Financial Services Authority of 25, The North Colonnade, Canary Wharf, London E14 5HS ("the FSA") gives you notice that it has taken the following action:

1. THE PENALTY

1.1. For the reasons listed below and pursuant to section 206 of the Financial Services and Markets Act 2000 ("the Act"), the FSA has imposed a financial penalty of £2.8 million on Scottish Equitable PLC ("Scottish Equitable"/ "the Firm"). This penalty is for breach of Principle 3 (Management and Control) of the Principles for Businesses ("the Principles") between 2002 and 2010 ("the Relevant Period").

1.2. Scottish Equitable qualified for a 30% (Stage 1) reduction in penalty, pursuant to the FSA's executive settlement procedures. Were it not for this discount, the FSA would have imposed a financial penalty of £4 million on the Firm.

1.3. Scottish Equitable will continue to carry out a customer redress programme with a view to providing redress to all customers affected. The Firm estimates the cost of redress will be £60 million, of which £30 million will have been paid by December 2010.

2. REASONS FOR THE ACTION

2.1. The breach of the Principle 3 set out below relate to a number of serious systems and controls failings by Scottish Equitable that have led to customer detriment during the Relevant Period.

2.2. Scottish Equitable breached Principle 3 in that between 2002 and 2010 it failed to take reasonable care to organise and control its affairs responsibly and effectively and failed to ensure that effective internal governance arrangements were in place to enable it to manage and monitor the risks its customers were exposed to in a number of areas. In particular:

(1) the Firm's lack of proper organisation and administrative procedures resulted in approximately 238,000 policyholder documents not being issued, of which 212,000 have been superseded by subsequent mailings but 26,000 potentially remain to be issued to customers;

(2) the Firm failed to trace in excess of 200,000 "gone away" policyholders;

(3) the Firm failed to calculate and deal with Guaranteed Minimum Pension ("GMP") payments correctly and significantly underestimated the value of future GMP benefits resulting in customer detriment for 774 customers of about £6-7 million;

(4) the Firm failed to identify and resolve systemic errors in calculating Fund Charge Rebates ("FCR") and Fund Value Rebates ("FVR") in respect of 25,000 policies resulting in customer detriment of about £5.7 million and £2.8 million respectively; and

(5) the Firm failed to match Department of Social Security now Department of Work and Pensions ("DWP") contributions to personal pensions for approximately 2,500 customers resulting in customer detriment in the region of £6.7 million.

3. RELEVANT STATUTORY PROVISIONS

3.1. The FSA's statutory objectives are set out in section 2(2) of the Act. The relevant objectives for the purpose of this matter are maintaining market confidence and the protection of consumers.

3.2. Section 206 of the Act provides that if the FSA considers that an authorised person has contravened a requirement imposed on him by or under this Act, it may impose upon him a penalty, in respect of the contravention, of such amount as it considers appropriate.

3.3. Scottish Equitable is an authorised person for the purposes of section 206 of the Act. Requirements imposed on the Firm includes the Principles made under section 138 of the Act, which provides that the FSA may make such rules applying to authorised persons as appear to be necessary or expedient for the purposes of protecting the interests of consumers.

3.4. Principle 3 provides that:

A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.

4. FACTS AND MATTERS RELIED ON

Background

4.1. Prior to 2009, the Firm identified and attempted to deal with problems arising from its back office functions and IT infrastructure on an ad hoc, decentralised basis. In May 2009, the Firm's senior management identified a number of issues with the Firm's organisational structure and initiated a project known as the "Legacy Management Programme" ("LMP") which aimed to identify and resolve all such issues and deliver improved operational effectiveness within the Firm.

4.2. In September 2009, the Firm informed the FSA that approximately 300 issues of varying complexity, scale and severity had been incorporated into the scope of the LMP, 35 of which were identified by the Firm as high priority because of their nature and/or the level of customer detriment.

4.3. Of these 35 high priority issues, the FSA investigated 5 issues which were most representative of the problems within the Firm and had resulted in consumer detriment, namely the Firm's failure to:

(1) issue policyholder documents;

(2) take adequate steps to trace "gone away" policyholders;

(3) ensure that GMP guarantees were calculated and transferred correctly in relation to section 32 contracts;

(4) identify and resolve systemic errors in calculating FCRs and FVRs; and

(5) take adequate steps to match DWP contributions to personal pensions in a timely manner.

4.4. The Firm has estimated that the consumer detriment arising out of the five LMP issues is approximately £22 million. The cumulative consumer detriment from all 300 issues included in the LMP is estimated to be in the region of £60 million.

Failure to issue documents

4.5. From March 2000 the Firm operated a document administration system which automatically generated policyholder documents for staff to check manually prior to issue. In July 2005, the Firm's Customer Services Division identified that there were a number of documents on the system which had not been issued, deleted or which were duplicates of documents already issued. Resolution of this was not prioritised and no action to deal with it was taken between July 2005 and June 2009. As a result of this, by September 2009 there were 238,000 unissued documents. Investigations by the Firm identified that of this number, 212,000 documents no longer needed to be sent to customers because the information they contained had already been communicated in subsequent documents. This matter is on target to be resolved by the end of March 2011. It is not clear whether this problem has resulted in any customer detriment.

Failure to trace "gone away" policyholders

4.6. The Firm became aware in 2007 that there was a large number of customers who had moved without informing them of their change of address, resulting in communications issued by the Firm being returned. This issue had existed since the early 1980s. Efforts were made to trace affected policyholders but those efforts were often sporadic and insufficiently effective. A new system was put in place in 2008 to trace new "gone away" cases but no attempt was made to deal with the backlog. When this issue was investigated as part of the LMP, the Firm estimated that there were approximately 200,000 'gone away' policyholders who had not been located. Steps have been taken by the Firm to trace all affected customers. Where this has not been successful, further methods, including detailed tracing, have now been employed. It is not clear whether this problem has resulted in any customer detriment.

Failure to ensure that Guaranteed Minimum Pension ("GMP") rights were calculated and transferred correctly

4.7. Section 32 policies (named after section 32 of the Finance Act 1981 (now repealed)) are available from insurance companies to allow paid-up pension rights and entitlements from a previous employment to be transferred to a new policy. Where the scheme member is transferring GMP rights from a contracted out scheme, the re-valued GMP rights will be provided at the state retirement age. Benefits can be taken between the age of 50 (55 on or after 6 April 2010) and 75 as well as a tax free lump sum.

4.8. The Firm believes it used an incorrectly calibrated spreadsheet between 1999 and 2007 which resulted in it making erroneous calculations. This was brought to the Firm's attention by a third party in 2007 at which point the spreadsheet error was corrected. The payment of redress is on target to be completed by the end of March 2011. The customer detriment arising from this issue is in the region of £6-7 million of which £4.85 million has been paid out by the Firm as redress as at 13 December 2010.

Failure to identify and resolve systemic errors in calculating Fund Charge Rebates (FCRs) and Fund Value Rebates (FVRs)

4.9. FCRs were introduced by the Firm in 1998 and FVRs in 2002. They are bonuses applied to a variety of products. Both utilised the same processing system and since both products were launched, a number of process, system and administration issues have been identified which have impaired the accurate application of these payments. This issue affects approximately 13,000 exited customers and 12,000 live policies. A number of historical projects were undertaken to address this issue in 2001, 2004, and 2007 – 2009, with limited success. The Firm's failure to prioritise and monitor the activities effectively led to the solutions being unsuccessful and the issue compounding. These are both issues which will be resolved by April 2011. The customer detriment arising from this issue is between £5.5 - 8.5 million, of which £3.5 million has been paid out by the Firm as redress as at 18 August 2010.

Failure to match DWP contributions to personal pensions.

4.10. The DWP makes payments to and recoveries from the Firm in relation to individuals on a monthly basis. Where an automatic match between payment and a policy is not possible, the contribution is held in suspense until a manual solution is found. In 2006, the Firm's auditors raised a concern relating to the amount of monies held in suspense. The Firm attempted to deal with this issue but in 2009 it discovered that the levels of DWP payments held in suspense had grown to approximately £3.5 million. It is estimated that from 1991, approximately 2,500 customers' contributions have been affected by this issue. As at 13 December 2010 the Firm had paid out £5.7 million in redress in relation to this issue, with a further £90,000 to be paid by the end of 2010.

External Report

4.11. An external consultant was engaged by the Firm in June 2009 to provide independent validation of whether the analysis, methodologies and execution of the LMP were robust and in line with the reasonable expectations of the FSA. No significant problems were identified by that consultant's work.

Progress

4.12. In January 2010, the FSA required the Firm to shorten the LMP timetable. The Firm was very responsive. It increased the resourcing of the LMP and shortened the completion date by a year to 2011 with low priority matters to be finalised in 2012. In August 2009 the LMP had 60 members of staff and a budget of £9.5 million. By June 2010, the programme employed 300 full time members of staff, with a budget of £22 million for 2010.

4.13. The FSA continues to closely monitor the progress of the LMP.

5. BREACH OF PRINCIPLE 3

5.1. Principle 3 requires that a firm takes reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.

5.2. The Firm failed to take reasonable care to organise or control its affairs responsibly and effectively by failing adequately to identify and resolve the 300 issues now identified in the LMP. When individual issues were first identified, including the five LMP Issues, the Firm failed to act responsibly, effectively and in a timely manner to resolve them adequately and in some cases did nothing at all. This resulted in the issues cumulating to such a degree that the period of time, amount of detriment and number of customers affected became substantial. The Firm did not act responsibly by allowing the situation to develop over 12 years. All these factors meant that resolution became so complex it resulted in yet further delay. A number of customers who would have been due redress have passed away in the intervening years. The FSA recognises that the Firm is making every effort to contact the custodians of the estates of those customers, and pay redress to their estates.

5.3. In addition the Firm failed to have an adequate and effective corporate structure in place resulting in inadequate risk management systems and an inability to identify, resolve and monitor risks as they arose.

5.4. The Firm has failed to have sufficiently robust governance arrangements and a clear enough organisational structure in place resulting in confusion and lack of clarity

regarding accountability. This directly contributed to many of the issues captured by LMP.

5.5. In addition the Firm failed to identify or manage or report risks and had inadequate administrative procedures and safeguard arrangements in place which mean that issues went undetected for a long time and were allowed to develop to an unacceptable level.

5.6. As a result of the above, the Firm is in breach of Principle 3.

6. THE SANCTION

Determining the level of penalty

6.1. The FSA's policy in relation to the imposition of financial penalties is set out in Chapter 6 of the Decision, Procedure and Penalties manual (DEPP) which forms part of the FSA Handbook. It was previously set out in Chapter 13 of the Enforcement Manual (ENF). These Manuals set out the factors that may be of particular relevance in determining the appropriate level of financial penalty for a firm or approved person. The criteria are not exhaustive and all relevant circumstances of the case will be taken into consideration.

Deterrence

6.2. The principal purpose of imposing a financial penalty is to promote high standards of regulatory conduct by deterring persons who have committed breaches from committing further breaches, helping to deter other persons from committing similar breaches and demonstrating generally the benefits of compliant behaviour.

The nature, seriousness and impact of the breaches

6.3. In determining the appropriate sanction, the FSA has had regard to the seriousness of the contraventions by the Firm, including the nature of the requirements breached, the number and duration of the breaches and the number of customers who have suffered financial loss. The FSA considers the Firm's failings to be serious because:

(1) the failings persisted over a significant period of time and impacted on a substantial number of customers;

(2) during the Relevant Period the Firm was aware of failings in relation to its activities but failed to take adequate steps to remedy and/or prevent further failings in a sufficiently timely manner; and

(3) the actual loss suffered by customers was substantial and in some cases financial remedy is no longer possible.

The extent to which the breach was deliberate or reckless

6.4. The FSA has not determined that the Firm deliberately or recklessly contravened regulatory requirements.

The size, financial resources and other circumstances of the person on whom the penalty is to be imposed.

6.5. The Firm has had regard to the size and financial resources of the Firm.

The amount of benefit gained or loss avoided as a result of the breaches

6.6. The FSA has not determined that the Firm has accrued any additional profits or avoided a loss through the way in which it operated its systems and controls.

Conduct following the breaches

6.7. The Firm has been given credit for referring the matter to the FSA, for identifying and resolving these historical issues and for co operating with the FSA by initiating the LMP and agreeing to a substantial customer redress programme.

6.8. The Firm has engaged external consultants to ensure the LMP is robust and sufficient. It has also committed substantial resources and time to ensure the timely resolution of LMP since January 2010. It has so far cost the Firm £22 million up until the end of 2010 to resource the LMP.

Disciplinary and compliance history

6.9. The Firm has not previously been the subject of disciplinary action.

7. CONCLUSION

7.1. Taking into account the inherited nature of these issues, all of which originated prior to the Firm being regulated by the FSA from 1 December 2001, the lack of timely and prompt action by the Firm during the relevant period which has resulted in serious breaches and posed a risk to the statutory objectives of the FSA, namely the maintenance of market confidence and the protection of consumers and having regard to all the matters set out above, the FSA proposes to impose a fine of £2.8 million on the Firm.

8. DECISION MAKERS

8.1. The decision which gave rise to the obligation to give this Final Notice was made by Settlement Decision Makers on behalf of the FSA.

IMPORTANT

8.2. This Final Notice is given to you in accordance with section 390 of the Act.

Manner of and time for Payment

8.3. The financial penalty must be paid in full by the Firm to the FSA by no later than 29 December 2010, 14 days from the date of the Final Notice.

If the financial penalty is not paid

8.4. If all or any of the financial penalty is outstanding on 30 December 2010, the FSA may recover the outstanding amount as a debt owed by the Firm and due to the FSA.

Publicity

8.5. Sections 391(4), 391(6) and 391(7) of the Act apply to the publication of information about the matter to which this notice relates. Under those provisions, the FSA must publish such information about the matter to which this notice relates as the FSA considered appropriate. However, the FSA may not publish information if such publication would, in the opinion of the FSA, be unfair to you or prejudicial to the interests of consumers.

8.6. The FSA intends to publish such information about the matter to which this Final Notice relates as it considers appropriate.

FSA contacts

8.7. For more information concerning this matter generally, you should contact Beth Harris at the FSA (direct line: 020 7066 2508/fax: 020 7066 2509).

Georgina Philippou
FSA Enforcement and Financial Crime Division