IN THE MATTER OF
THE DISCIPLINARY TRIBUNAL OF THE FINANCIAL REPORTING COUNCIL
AND IN THE MATTER OF:

THE EXECUTIVE COUNSEL TO

THE FINANCIAL REPORTING COUNCIL

-and-

(1) MR DOUGLAS MORGAN

(2) KPMG AUDIT PLC

(3) MR MARK TAYLOR

(4) MR ANTHONY HULSE

DECISION OF THE DISCIPLINARY TRIBUNAL

A. INTRODUCTION

1. In these proceedings the parties agreed a Statement of Facts, with a view to providing an overview of some of the key uncontested facts in order to assist the Tribunal. The Statement of Facts was not intended to constitute a comprehensive recitation of the factual record, or to limit the parties' right to rely upon facts or matters not specifically included in the Statement. However, the Statement of Facts introduces the various parties to the present proceedings and sets out an essential introduction for understanding the nature of the case brought by Executive Counsel, as well as flagging the issues that arise for determination. It is, therefore, by way of introduction reproduced below.

STATEMENT OF FACTS:

2. Mr Douglas Morgan ("Mr Morgan") is a former director of Equity Syndicate Management Limited ("ESML") and a member of the Chartered Institute of Management Accountants ("CIMA"). Mr Morgan was Finance Director of ESML from 27 September 2006 to (or at least until) 30 March 2010. Upon appointment as Finance Director, Mr Morgan assumed board level responsibility for finance, investment, credit and reserving, including in relation to Syndicate 218 ("the Syndicate").

3. KPMG Audit Plc ("KPMG") is a member firm as defined in paragraph 2(1) of the Accountancy Scheme. KPMG audited the financial statements for Syndicate 218 for the financial reporting years ending 31 December 2008 and 2009.

4. Mr Mark Taylor ("Mr Taylor") is a partner of KPMG, and a member of the ICAEW. Mr Taylor was the Responsible Individual ("RI") for the Syndicate 218 audit in the 2008 and 2009 years, at which time he was an Associate Partner at KPMG.

5. Mr Anthony Hulse ("Mr Hulse", together with KPMG and Mr Taylor, "the KPMG Respondents") is a former partner of KPMG, and a member of the ICAEW. At the time of the audits for the 2008 and 2009 years, Mr Hulse was the lead partner for the [...] – KPMG relationship and was the RI for [...] Ltd. Mr Hulse was involved in the audit of Syndicate 218 for the 2008 and 2009 years and in the latter he was involved specifically in aspects of the audit team's work concerning Syndicate 218's reserves.

6. In relation to each relevant audit year, KPMG engaged their own in house actuarial team (the "KPMG Actuaries") for the purpose of reviewing work done by ESML's external actuaries […] in relation to Syndicate 218's reserves. The KPMG Actuaries were part of the audit team. The lead KPMG actuarial member of the audit team for the 2008 year was […], an Actuarial Senior Manager, assisted by […], an Actuarial Senior and […], an Actuarial Analyst. […] and […] were also involved in the 2009 audit. Beginning in/around mid-January 2010, […], a KPMG Actuarial Partner, was brought in to provide additional actuarial expertise and supervision. The KPMG Actuaries also had junior support from […], an Actuarial Analyst.

7. KPMG and Mr Taylor provided an unqualified audit opinion on the Syndicate 218 Syndicate Annual Accounts ("SAA") for the 2008 and 2009 years.

Syndicate 218

8. At all material times, Syndicate 218 was a Lloyd's Syndicate writing primarily motor insurance. Its managing agent was ESML.

9. In January 2007, "[...]" acquired […], the companies in which included ESML and […]. In 2008 and 2009, [...] (through […]) provided the majority (around 64% for the

2009 year of account) of the underwriting capacity for Syndicate 218, the balance being provided by Lloyd's "names" that were not owned by [...].

10. In Syndicate 218, as in other Lloyd's Syndicates, each calendar year represented a separate business venture, with any profit or loss arising from insurance contracts written during the year falling on the participants (names and corporate members) in that year alone. However, for each underwriting year, or year of account ("YOA"), the final cost of all claims would not be known until all had been paid, generally many years after the end of the relevant year.

11. In accordance with normal Lloyd's practice, each underwriting year "closed" after three years and any outstanding liabilities were transferred into the next "open" year. This process involved the calculation of a sum representing the total expected costs of unpaid claims, net of reinsurance, plus expenses, which would be paid by the closing year to the open year by way of a "Reinsurance to Close" ("RITC") premium. The amount of the RITC premium would be a significant factor in calculating the amount of profit or loss of the closing YOA.

12. Each year ESML, as a Lloyd's managing agent, was required by Lloyd's regulations to produce on behalf of Syndicate 218 both the SAA and Syndicate Underwriting Year Accounts ("SUYA") (together the "Syndicate Accounts").

13. The SAA aggregated all of the transactions which had taken place in the reporting year regardless of which underwriting year they related to. They included all of the assets and liabilities relating to all of the underwriting years which had not been finally collected or settled. The SAA thus reported provisions for liabilities arising from outstanding claims ("Outstanding Claims Provisions") for the Syndicate as a whole for all underwriting years.

14. The SUYA related only to the closing underwriting year, and would reflect the premiums, ultimate claims and expenses, and consequently the profit or loss, for the year in question. The Outstanding Claims Provisions for that year would be shown as the RITC premium. For example, at 31 December 2009, the 2007 underwriting year closed, and SUYA were prepared showing the results for that YOA alone. The RITC premium was received by the 2008 underwriting year, which remained "open".

15. From 2007 to 2010 (and earlier) ESML engaged [...] to provide actuarial services, including calculating a "best estimate" of total outstanding claims as at the relevant accounting date. This was required by Lloyd's in the form of a "Statement of Actuarial Opinion" ("SAO"), giving assurance that the reported provisions were no less than that estimate. The SAO was signed by Mr James Rakow, [...], as the signing actuary ("Mr Rakow"). For each of the 2008 and 2009 audit years, the SAOs were unqualified and expressly acknowledged that KPMG would rely upon them. As explained below, a Formal Complaint was brought against Mr Rakow by the Executive Counsel but was settled by Mr Rakow admitting misconduct on an agreed basis (see paragraphs 103 and 104 below).

16. In or around October 2009, ESML hired an in-house actuary, [...] ([...]), who had previously worked for [...]. While at [...], [...] had worked on the Syndicate 218 reserves.

17. ESML generally added a "risk margin" to the "best estimate" for each YOA when calculating the provisions for inclusion in the Syndicate Accounts. In 2009 ESML applied a zero margin to the 2007 closing YOA.

18. Mr Morgan was responsible for signing a Data Accuracy Statement ("DAS") confirming that complete and accurate information had been provided to [...].

19. The KPMG Respondents were responsible for auditing the SAAs in 2008 and 2009, and reporting to the members whether, in the auditor's opinion, the SAAs gave a true and fair view of the state of Syndicate 218's affairs at the end of each of those financial years, and of its profit or loss for that financial year in accordance with the relevant financial reporting framework.

Claims reserving at ESML

20. ESML, in common with other general insurance businesses, employed a claims reserving process, the aim of which was to recognise the extent of claims liabilities that were expected to arise in relation to business already contracted.

21. At all material times, claims handlers within Syndicate 218 were expected to place an initial reserve on each notified claim (a "case reserve" or "case estimate"). This could be a standard reserve for the particular type of claim or a specific reserve based on information received about the likely cost to settle the claim. The initial reserve was to be adjusted as further information regarding the claim was received, for example an engineer's report giving details of repair costs, or medical reports detailing the extent of injuries suffered by an accident victim.

22. In the simplest cases, the claim might be resolved, with the value agreed and all payments made, in a matter of weeks. In complicated cases, particularly those involving serious injuries and where the claim ultimately resulted in litigation, the claim would remain live, and the reserve continue to be adjusted for changing circumstances, for several years. In those types of cases some liabilities might be agreed and paid during the early stages of the claim whilst others would not be settled until much later. At any given time, therefore, ESML's systems would record, for each claim, and in aggregate, amounts already paid out ("paid claims") and the case handlers' estimates of further amounts that would ultimately need to be paid to settle the claim ("outstanding claims"). The sum of these two amounts is known as "incurred claims".

23. A further element of actuarial estimates normally recognised by insurers is known as Incurred but not Reported ("IBNR"). IBNR is a figure calculated in respect of insurance claims where liability has arisen but the claim has not yet been reported to the insurer. IBNR also includes unexpected future development on claims that have been incurred and reported, and claims that have been recorded as settled but which are subsequently re-opened due to further liabilities arising. A negative IBNR figure reflects a position where, notwithstanding these potential additional claims, the incurred claims are considered likely to be at a level higher than the ultimate liability that will arise from all claims.

24. As a result of the matters referred to in the above paragraphs Syndicate 218 tended to show a negative IBNR figure in its accounts.

25. At all material times, the Syndicate Accounts included amounts of Syndicate 218's Outstanding Claims Provisions (comprising the estimated ultimate cost of settlement of all incurred claims, including IBNR, and related claims handling expenses). The Outstanding Claims Provisions were based on actuarial estimates. Calculating these estimates is a complex task requiring considerable amount of judgement and in ESML's case was performed by [...].

The File Review Process

26. ESML conducted a "claims file review" exercise annually until 2008 and then (after [...] took over ESML and introduced a new reporting schedule) bi-annually from 2008. The file reviews involved recorded estimates being reviewed and adjusted by a small team of experienced claims handlers to remove redundancy.

27. In addition to the "file reviews", ESML also carried out "virtual file reviews" at the request of [...]. These differed from the file reviews in that no changes were made to case reserves on underlying files. A spreadsheet was produced to [...] which recorded the case reserves on the files and the outcome of the virtual file review.

KPMG's Audit Work

28. In 2008 and 2009 the audit work conducted by KPMG included, inter alia, the following features:

    (1) The setting of reserves was identified as a significant risk in KPMG's planning documents.

    (2) KPMG included the KPMG Actuaries within the engagement team to review aspects of [...]'s work. For both the 2008 and 2009 year end audits, the KPMG Actuaries reviewed [...]'s work and prepared a report documenting their findings and concluding that [...]'s estimates were not unreasonable. The Executive Counsel has not issued a Formal Complaint in respect of the KPMG Actuaries.

    (3) Members of the audit team conducted certain tests of samples of the Syndicate's claims files.

    (4) KPMG audit team members met with claims staff and discussed, amongst other topics, changes to claims processing methods, and the increases in paid claims, acceleration and claims leakage.

Development of paid claims and internal process changes at ESML

29. ESML became aware that there was an increase in the claims payments for each underwriting year, compared to earlier years at the same point of development. Mr Morgan and at least some other senior executives took the view that a proportion of the observed increase in claims payments could be explained by two phenomena:

    (1) the paying of claims more quickly than had been the case in the past (claims "acceleration");

    (2) paying more for each claim than would, or could, have been the case if more time and care had been exercised (claims "leakage").

30. Mr Morgan says that he believed the cause of both acceleration and leakage to be changes in claims handling processes that had been introduced in around November 2006 by [...], the new head of claims who had been recruited by ESML. [...] had overseen changes intended to speed up the settlement of simple, low value claims, in the belief that this would reduce overall costs.

31. In 2007 [...] were commissioned by [...] to investigate the causes of increasing motor claims costs in ESML and another business ([...]) and it published a report dated October 2007 (the "2007 [...] Report").

32. Based on data available as at August 2007, [...] analysed historical claims data between January and August for each of 2005, 2006, and 2007 and concluded *"in summary, the rise in real claims costs after allowance for portfolio growth appears to have been driven by acceleration in payments, changes in underwriting, and subsequently mix of business, some increase in claims leakage and environmental factors."* The 2007 [...] Report estimated that [...] experienced a £26.8 million increase in claims costs. So far as can be quantified, the breakdown of that estimated increase was £6.8m due to acceleration, £4.7m driven by third party capture, £4.6m in total losses, £4.2m due to broker activity, £3.5m due to claims leakage and £3m due to floods). [...] identified nine other potential factors, which were not directly quantifiable.

33. In 2008 ESML decided to reverse [...]'s process changes, in order to seek to reduce leakage. [...] left ESML in early 2009 and was replaced as head of claims by Mr [...] ("Mr [...]").

Brief overview of events relating to the audit and approval of 2008 financial statements

34. On 19 November 2008, Mr Hulse and Mr Taylor presented KPMG's audit strategy and planning presentation to the ESML Audit Committee. The presentation, among other things, summarised KPMG's proposed audit approach and timetable for the audit of the year ending 31 December 2008 and documented KPMG's initial assessment of the significant audit risks, and outlined accounting issues which may affect the Syndicate's audit and financial statements. Reserving was identified as the most significant audit risk, and the most significant and judgmental area of the financial statements. KPMG noted that the assumptions made in respect of reserving would have a material impact on the financial statements and the results for the year, and that the process would involve actuarial input and judgment. For these reasons, KPMG explained that it would engage its actuarial team to review the reserving work undertaken by [...] and ESML in order to assess the appropriateness of their key judgments and methodologies employed.

35. On 27 November 2008, KPMG held an internal audit "kick off" planning meeting attended by, among others, Mr Hulse, Mr Taylor and KPMG's actuaries [...] and [...]. The note records discussion of the need to make sure that KPMG was comfortable from an actuarial perspective with [...]'s methodology.

36. In November and December 2008, KPMG performed interim fieldwork, which included, among other things, interviews of key class underwriters, the head of claims ([...]), and other individuals in key functions.

37. Following work carried out by KPMG and [...], with input from ESML, on 28 January 2009 the ESML Audit Committee, attended by Messrs Morgan, Hulse and Taylor among others, met to discuss, among other things, [...]'s best estimate figures, for inclusion in [...]'s half year results. At the time of the meeting KPMG's actuaries had seen the central estimates calculated by [...] but had not seen [...]'s final report and as such KPMG's work in that area was ongoing.

38. At that meeting, KPMG presented its salient features memorandum for [...] reporting purposes to the Audit Committee. KPMG's presentation noted, amongst other things, that (i) claims were higher primarily due to the deterioration seen on the 2007 YOA, which had been particularly affected by adverse claims development and changes in the internal claims processes which had resulted in increased claims leakage; and (ii) based upon the draft information received, [...]'s central estimates would appear a reasonable basis for reporting, but work in this area would be ongoing until KPMG received [...]'s final figures.

39. [...] provided the KPMG Actuaries with a presentation in respect of its draft reserving results for the year ended 31 December 2008 on 28 January 2009. On 2 February 2009, following their performance of additional work, including discussions with [...] and with members of the KPMG core audit team, the KPMG Actuaries provided the core KPMG audit team, including Messrs Taylor and Hulse, with their Actuarial Audit Memorandum, which concluded, for the reasons given and subject to the reliance and limitations identified therein, that having reviewed [...]'s work they were satisfied that the reserves held by management were not unreasonable.

40. On 18 February 2009 Mr Rakow of [...] signed an unqualified SAO for Syndicate 218 as at 31 December 2008, confirming that in his opinion the technical provisions for solvency identified above complied with the Lloyd's Valuation of Liabilities Rules

and each was not less than the expected future cost of the corresponding claims and claim handling expenses for which Syndicate 218 was liable at 31 December 2008.

41. On 18 February 2009 the ESML Audit Committee met, with Messrs Morgan, Taylor and Hulse in attendance, as well as members of ESML's management. Messrs Taylor and Hulse delivered their final audit presentation, updating their audit salient features presentation of 28 January 2009. In its presentation KPMG reiterated that there had been deterioration in the 2007 YOA which had been particularly affected by adverse claims development and changes in the internal claims processes which had resulted in increased claims leakage. KPMG further noted that it was content that the overall results of [...]'s central estimates represented a reasonable basis for reporting.

42. At the meeting the margin was discussed, and ESML decided to apply a margin of 3.5% above [...]'s central estimate for the 2008 YOA.

43. After the Audit Committee meeting on 18 February 2009, there was also a meeting of ESML's Board at which Mr Taylor presented the key points which had been discussed at the Audit Committee.

44. On 27 February 2009 [...] produced its Syndicate 218 Valuation as at 31 December 2008 for [...] half year group reporting purposes.

45. On 18 March 2009 Mr Taylor signed the 2009 SAA and SUYA, giving an unqualified audit opinion.

46. On 24 March 2009, [...] produced its final report, setting out its Syndicate 218 Review of Technical Provisions as at 31 December 2008.

Brief overview of events relating to the audit and approval of 2009 financial statements

47. In June 2009 the ESML claims department produced a report into claims handling practices and, based on a review of 18 files, identified hard leakage of £1,500 per file.

48. On 18 November 2009, Mr Hulse and Mr Taylor presented KPMG's audit strategy and planning presentation to the ESML Audit Committee. The presentation, among other things, summarised KPMG's audit approach and timetable for the year ending 31 December 2009 and documented its initial assessment of the key audit risks. Reserving was identified as the most significant audit risk, and the most significant and judgmental area of the financial statements.

49. On 25 November 2009, KPMG held an internal audit "kick off" meeting attended by, among others, Mr Taylor and KPMG's actuaries [...] and [...].

50. KPMG undertook its interim fieldwork during November and December 2009.

51. On 2 December 2009, Mr [...], a claims supervisor in the large loss claims unit of ESML, emailed Mr [...], then head of claims at ESML, setting out the amounts of "redundancy" which had been removed as at that date during 2008 and 2009. An amount of case reserves was treated as "redundant" when, on a file review, that

amount was considered to be in excess of the "best estimate" of the required reserve for the claim in question. Mr [...]'s email stated, among other things, that the following amounts of "redundancy" were removed from the 2005 to 2008 YOAs in the 2009 bi-annual file review:

(1) In file reviews undertaken between the end of February and May 2009: 2005 YOA £14,000,827, 2006 YOA £17,062,678, 2007 YOA £17,000,023 and 2008 YOA £13,512,939.

(2) In file reviews undertaken from September 2009 until 2 December 2009: 2005 YOA £3,177,424, 2006 YOA £4,404,260 and 2007 YOA £17,743,981.

52. This email (or the information therein) was not passed on to [...] or KPMG and Mr Morgan was not copied to the email.

53. In early December 2009, Mr Taylor and Mr Hulse had lunch with Mr [...]("Mr […]") (who had recently re-joined ESML/[...]) at which Mr [...]raised his concern that Syndicate 218's reserves might be light, and that Syndicate 218 had been given the benefit of the doubt as regards the effects of the changes to claims processing implemented by [...]. The KPMG Respondents were also aware at this time that there was a risk that Syndicate 218's 2007 YOA may close at a loss – which would be the first time a YOA had closed at a loss in around 40 years.

54. On 21 December 2009, Ms [...] of [...] emailed Mr [...] of ESML in relation to a virtual file review for 2005 and 2006. The email stated that [...] was working on the basis that there were no further savings on certain claims in the 2005 and 2006 YOAs.

55. On 13 January 2010 Mr Hulse emailed [...], a Partner in KPMG's actuarial team in relation to [...] attending a meeting with [...] on 15 January 2010. Thereafter [...] assisted in the actuarial work as part of the audit team.

56. On 15 January 2010 individuals from ESML and KPMG (including [...] and Messrs Morgan, Taylor, [...] and [...]) met [...] at ESML's offices and [...] gave a presentation in respect of its draft reserving results for the year ended 31 December 2009, which was based on the November 2009 data.

57. On 20 January 2010, Mr Morgan spoke with Mr [...] ("Mr [...]"), the KPMG audit manager for the 2009 year end audit, about the audit. Mr [...] referred to the conversation in an email to Mr Hulse and Mr Taylor that day.

58. On 26 January 2010, for the purposes of [...]'s half-year reporting, [...] emailed Mr Taylor the KPMG Actuaries' conclusions on [...]'s work on the reserves in a document entitled "Actuarial Review". Based on the work done at that time (which did not yet include data from December 2009), the KPMG Actuaries concluded that the reserves proposed by [...] were not unreasonable, albeit at the lower end of the reasonable range of results which might be produced. The KPMG Actuaries drew attention to a number of uncertainties in the paid and incurred development patterns.

59. Among other items, the Actuarial Review addressed in detail the changes in methodology adopted by [...], and the related assumptions, as well as presenting the results of sensitivity testing performed by the KPMG Actuaries to test those assumptions.

60. On 27 January 2010 the ESML Audit Committee, attended by Messrs Morgan, Hulse and Taylor among others, met to discuss the draft Syndicate results for the year ended 31 December 2009. At that meeting, Mr Morgan reported that there had been a significant deterioration in the claims reserves of the Syndicate in relation to the 2007 and prior years of account. The overall impact resulted in a deterioration on the 2007 account and prior years of £23.5m, and also a small deterioration in ultimate claims on the 2008 year of account.

61. Mr Hulse and Mr Taylor also gave a presentation entitled "Equity Syndicate Management Limited – Extracts from the [...] (UK) Holdings Review Memorandum for the six months ended 31 December 2009". That presentation was an abbreviated version of the Highlights Memorandum which was presented by Mr Hulse to the [...] Audit Committee on 29 January 2010 (summarised below). In the 27 January 2010 presentation, KPMG concluded that [...]'s central estimates were not unreasonable but there remained significant uncertainties in relation to the central estimates set for the 31 December 2009 reporting, in particular (i) changes made to the claims function and the impact it had had on the speed and development of claims payment patterns and therefore on the level of ultimate claims; and (ii) market trends seen in relation to severity and frequency of bodily injury claims, in particular the impact of economic conditions and claims farming and the impact this had on overall claims costs.

62. That presentation also noted, amongst other things, that from KPMG's understanding of the business developed over its tenure as auditors and analysis of historical data it could be seen that [...] generally reserves very prudently on case reserves, that KPMG had obtained a presentation from [...] which graphically demonstrated the development of paid and incurred claims by year of account and that a key consideration was whether and how the redundancy seen on prior years of account would be manifested in the future.

63. Mr Morgan reported at the ESML Audit Committee meeting that [...]'s estimates showed that there had been a significant deterioration in the claims reserves of Syndicate 218 in relation to the 2007 and prior years of account. There had been a continued strong payment trend seen in the past six months, particularly on the 2005 to 2007 years of account. The overall impact resulted in a deterioration on the 2007 account and prior years of £23.5m and also a small deterioration in ultimate claims on the 2008 year of account.

64. On 29 January 2010 Mr Hulse presented KPMG's highlights memorandum to the [...] Audit Committee for [...] reporting purposes, which stated, among other things:

    (1) That the expected improvement in the paid claim development pattern, anticipated as part of the 30 June 2009 reserving process had not materialised during the last six months of 2009;

    (2) That had resulted in the reserves for the 2007 and prior years being strengthened by £23.5m as at 31 December 2009;

    (3) [...] continued to give credit for the expected slowing in the paid claim development on the 2008 and 2009 underwriting years in the 31 December 2009 reserving which together with market trends seen in relation to severity and frequency of bodily injury claims, in particular in light of current

economic conditions and claims farming practices gave rise to significant uncertainty over the setting of the central estimate; and

(4) Investigations were continuing to understand whether the paid claims development was caused by genuinely higher claims or a continued faster payment pattern.

65. During February 2010, [...] and ESML undertook additional work in respect of the reserves using the December data, and the KPMG team continued audit work.

66. The February ESML Audit Committee meeting was scheduled for 24 February 2010. In the early hours of that day, the KPMG audit team received [...]'s final appendices detailing [...]'s best estimates as at 31 December 2009, as well as Mr Morgan's updated board paper (an earlier version having been provided to KPMG on 22 February 2010) on Syndicate 218's results based on [...]'s revised best estimate.

67. The same morning, the KPMG Actuaries received a three page note prepared by Mr Rakow regarding his best estimate and the methodologies he had employed. Mr Rakow's note explained that having considered the December data, [...] had performed additional work, including a sample of virtual file reviews on Focus capped claims for the 2006 and 2007 years, as well as analysis of the Focus 5k database. The result of [...]'s further work was that Mr Rakow's best estimate was required to be increased by £4.7 million.

68. On 24 February 2010 the ESML Audit Committee met at a full ESML Board meeting, with (amongst others) Messrs Morgan, Taylor and Hulse in attendance, to discuss [...]'s calculation of the reserves for Lloyd's reporting purposes. At the meeting Mr Morgan circulated Mr Rakow's note. The Board concluded that until [...] provided their final conclusions in relation to the key judgments to KPMG and the Board, the Board could not obtain sufficient comfort to justify the reserves reflected. As a result, it was agreed to request an extension from Lloyd's in relation to the filing of the Lloyd's return, which was then due the following day.

69. Messrs Taylor and Hulse (along with Mr [...]) had prepared an audit presentation noting, among other items, the further work undertaken by [...] on reserves and that there remained a number of areas to be finalised by management. It also noted that that KPMG had not yet been provided with [...]'s revised best estimate.

70. At the 24 February 2010 meeting ESML resolved to ask [...] to consider rebating £6m in corporate expenses, which would have the effect of putting the 2007 YOA back into profit. The ESML Board also resolved to add no margin to the 2007 YOA, which again would result in 2007 YOA returning a profit.

71. On 24 February 2010 [...] produced its Syndicate 218 Valuation as at 31 December 2009 for [...] half year group reporting purposes.

72. On 25 February 2010 [...] produced a more detailed report setting out its conclusions on the reserves. Consistent with Mr Rakow's note circulated to the Board and Audit Committee at the 24 February 2010 meeting, the 25 February 2010 [...] report concluded that the reserves for the Motor Focus 2007 account needed to be increased by £4.7 million.

73. [...]

74. Between 26 and 28 February 2010, the KPMG Actuaries performed a review of the revised [...] analysis, which included discussions with ESML and [...].

75. On 1 March 2010 Mr Rakow of [...] signed an unqualified SAO for Syndicate 218 as at 31 December 2009, confirming that in his opinion, the technical provisions for solvency identified above complied with the Lloyd's Valuation of Liabilities Rules and each was not less than the expected future cost of the corresponding claims and claim handling expenses for which Syndicate 218 was liable at 31 December 2009.

76. On/around 1 March 2010, Mr Hulse recorded in his notebook that Mr [...]had confirmed that he would sign the Syndicate return at the meeting.

77. On 2 March 2010 Mr Hulse had a series of discussions and email exchanges with the KPMG Actuaries, who in turn spoke to and obtained further information from [...] and [...] during the course of that day to complete their review of the revised [...] analysis. Following that additional work and those discussions, Mr Hulse recorded in his notebook the outcome of the discussions which the KPMG Actuaries had had with [...] and their conclusion that [...]'s methods were not strong but were not unacceptable.

78. On 2 March 2010, Mr Hulse recorded in his notebook that he spoke with Mr Morgan in relation to changes in case estimation practices.

79. On 17 March 2010 Mr Hulse and Mr Taylor (amongst others) attended the ESML Audit Committee meeting and presented a paper dealing with matters coming to KPMG's attention during the course of the audit, for management to consider.

80. On 18 March 2010 Mr Morgan signed a Letter of Representation from the Board of Directors of ESML to KPMG, which stated as follows: *"The board confirms that the methodology employed by the Syndicate and its outsourced claims providers, namely* […]*, in relation to the setting of case reserves both for bodily injury and larger accidental damage claims have remained consistent throughout the period from 2002. The board also confirms that the changes made to claims processes in recent periods have not impacted the case reserving philosophy or basis employed by claims handlers".*

81. On 18 March 2010 Mr Taylor signed the 2009 SAA and SUYA, giving an unqualified audit opinion.

82. On 30 March 2010 [...] emailed Mr Taylor an updated version of the KPMG Actuaries' January 2010 Actuarial Review, which Mr Taylor asked him to date 2 March 2010, as that was when the conclusion was reached.

83. On 14 April 2010, [...] produced its final report, setting out its Syndicate 218 Review of Technical Provisions as at 31 December 2009.

Further investigations following the signing of the 2009 SAA and SUYA

84. In early April 2010 Mr […], the incoming Finance Director of ESML (replacing Mr Morgan), asked [...] to carry out a review to confirm whether [...]'s 31 December 2009 projections remained appropriate.

85. [...] produced a draft note, sent to the ESML executive team on 14 April 2010, concluding that the strong claims payments experienced during the first quarter of 2010 had invalidated some of the actuarial modelling assumptions previously used by [...] and indicated a further deterioration in claims reserves of around £50.5m. [...]'s note was updated and reissued and shared with [...] senior management.

86. On 28 April 2010, at a meeting between ESML and [...] senior management in [...], it was agreed that ESML and [...] would commission an independent external actuarial review and Mr [...]was asked to lead the work.

87. Dr […] of [...] was asked to carry out the independent actuarial review. Between 11 May 2010 and 2 June 2010 she prepared various reports, working through a number of projections or bases.

88. Dr […] 's final report dated 2 June 2010, which took account of data up to May 2010, concluded that ultimate claims as at 31 December 2009 to that estimated by [...] at the 2009 year had deteriorated by £212.5 million. The same day [...] made a stock exchange announcement announcing a one-off charge of AUS$365 million due to significant deterioration in its UK business.

89. On 10 August 2010 Dr […] produced a further report, taking into account the June 2010 data, and concluded that the total deterioration in the 2001 to 2009 YOAs as at 31 December 2009 compared to [...]'s 2009 year end estimate now stood at £261.9 million.

90. […]

91. In late August 2010 the FSA notified ESML that pursuant to s. 166 of the Financial Services and Market Act 2000 (FSMA), it required ESML to appoint a skilled person to provide the FSA with a report on corporate governance arrangements concerning claims and actuarial reserving and their effectiveness in practice. [...] was subsequently appointed as the skilled person tasked with producing the s. 166 report.

92. On 3 September 2010 […] Ltd produced a report into the strength of case estimates in which, having reviewed a stratified sample of 398 open third party claims, it concluded that *(inter alia) "within the TP claims population as a whole Equity should not anticipate significant reserve releases"*.

93. On 11 March 2011, having carried out various interviews and investigations, [...] produced its s. 166 report which assessed and made recommendations relating to ESML's decision making regarding claims and actuarial reserving; the relation between the setting of case reserves and actuarial reserves; conflicts of interest; whether benefits could be derived as a result of claims and actuarial reserving practices; and the effectiveness of the link between claims experience and the setting of rates.

Overview of Syndicate 218's financial statements

94. Prior to 2007, Syndicate 218 had consistently reported profits for many years. In the following years, Syndicate 218 reported decreasing profits for each closing YOA, and eventually a multi-million £ loss in the 2010 SAA. In summary:

SAA Year	**Gross Premium £m**	**Profit £m**
2007	569	25
2008	555	7
2009	635	15
2010	527	(499)

SUYA (Underwriting Year)	**Gross Premium £m**	**Profit £m**
2007 (2005)	535	63
2008 (2006)	514	22
2009 (2007)	580	0.2
2010 (2008)	511	(238) unclosed run-off

95. In the SUYA for 2011, it was stated that the final loss for the 2008 underwriting year amounted to £248 million, of which £143 million was attributable to the business reinsured into the 2008 underwriting year from the 2007 underwriting year.

96. The Syndicate's SAA for 2010 noted that, in the light of information available at 17 March 2011, when the Syndicate's SAA for 2010 was approved, the outstanding claims provisions at 31 December 2009 should have been £267 million higher.

The Lloyd's Enforcement Proceedings

97. In October 2011, two charges of detrimental conduct were brought against Mr Morgan before the Lloyd's Enforcement Tribunal, pursuant to section 3(b) of the Enforcement Byelaw (No. 6 of 2005). They related to:

(1) Mr Morgan's alleged failure to take reasonable steps to ensure that there were sufficient systems and controls in place including the maintenance of an adequate standard of documentation, in relation to certain aspects of the Syndicate's reserving processes;

(2) Mr Morgan's alleged failure, in part as a result of these same systems and controls failures, to put himself into a position, as the director with responsibility for the 2009 year-end process and as the signatory of the

relevant DAS, to be able to ensure that accurate and complete information had been provided to the Syndicate's external actuaries in respect of two reports prepared as at year end 2009.

98. On 14 March 2013, Mr Morgan admitted, for the purposes of the Lloyd’s Enforcement proceedings alone, two charges of detrimental conduct before the Lloyd’s Enforcement Tribunal, as set out in the Notice of Censure.

99. In particular, Mr Morgan admitted in relation to Charge 1 that as the Finance Director and as the director who organised and directed the file reserve review process he had responsibility for ensuring adequate systems and controls were in place in relation to Equity’s reserving processes and that he did not take sufficient steps to ensure:

(1) that certain aspects of the reserve review process and the results of each reserve review were properly documented by those charged with those tasks; and

(2) that the ESML Board and [...] were kept properly informed as to the reserve review process and the results of each reserve review.

100. Mr Morgan admitted in relation to Charge 2 that he was the director responsible for the 2009 year-end process and was the signatory of the relevant DAS. Mr Morgan accepted that he had responsibility for ensuring that accurate and complete information was provided to the Board and [...] and admitted:

(1) due in part to the governance issues over the reserve review process set out above in respect of Charge 1, Mr Morgan was not able to satisfy himself that accurate and complete information regarding the reserve review process was provided to the external actuary; and

(2) that he then did not read the [...] reports dated 24 February 2010 and 14 April 2010 (referred to further below) and consequently was not in a position to correct any errors that they may have contained.

101. The Notice of Censure recorded a number of matters by way of mitigation. Mr Morgan undertook not to apply for a position as a director of a Lloyd’s firm for 3 years, which sanction Mr Morgan has observed and which expired on 14 March 2016.

102. The Lloyd’s Enforcement Tribunal also brought proceedings against Syndicate 218’s Active Underwriter, Mr Josiah. Mr Josiah admitted those charges, as recorded in Lloyd's Notice of Censure.

The Executive Counsel’s Proceedings in Relation to Mr Rakow

103. On 22 August 2016, the Executive Counsel served a Formal Complaint against Mr Rakow making three allegations of misconduct pursuant to the Actuarial Scheme of 1 June 2014 relating to the 2007, 2008, and 2009 YOAs for the Syndicate.

104. On 18 May 2017, Mr Rakow and the Executive Counsel entered into a settlement agreement in respect of an amended formal complaint which asserted two allegations

against Mr Rakow in relation to the 2008 and 2009 YOAs (the "Settlement Agreement"). Mr Rakow accepted in the Settlement Agreement that his conduct in respect of the SAO engagements for the years ending 31 December 2008 and 2009 fell significantly short of the standards reasonably to be expected of a Member and that he ought not to have signed the 2008 and 2009 SAOs.

B. THE PROCEEDINGS

105. On 22 August 2016 a Formal Complaint in the present matter was issued under the Accountancy Scheme, and on 16 February 2017 Mr Morgan, KPMG, and Mr Taylor and Mr Hulse served their Formal Defences. Executive Counsel served Replies to the Defences on 31 March 2017. There was a directions hearing before the Legal Chair of the Tribunal on 7 December 2016, following which directions for the further conduct of the proceedings were given on 30 December 2016.

106. On 4 October 2016 Executive Counsel served a witness statement from Mr [...]dated 5 August 2016. From September 2005 to August 2006 he had been Group Chief Finance Officer of […], then the ultimate owner of ESML, and Finance Director of ESML. On 1 December 2009 he joined [...], with a view to becoming its Chief Finance Officer and Finance Director of ESML. A second witness statement from Mr [...]dated 1 October 2017 was served on 2 October 2017.

107. On 20 July 2017 Mr Morgan served his witness statement, and on 20 July 2017 witness statements were served for Mr Taylor and Mr Hulse dated 19 July 2017 and 20 July 2017, respectively. On 16 November 2017 Mr Taylor served a second witness statement.

108. Executive Counsel served two expert reports. The first was a report dated 26 July 2016 from Mr Mark Collier. He had been Managing Director of […] from 2001 to 2008, and was currently an executive and personal coach. The second report dated 4 August 2016 was from Mr Alastair Campbell. He had been a partner in […] Chartered Accountants from 1970 to 2010, and subsequently has been working as a company director and independent consultant.

109. There were two expert reports served on behalf of Mr Morgan. The first was dated 1 September 2017 from Mr Charles Portsmouth. He is a Fellow of the Institute of Chartered Accountants. He was an accountant at […] from 1978 until 1990, when he became Group Finance Director of a Lloyd's insurance broking group, later becoming Finance Director of a Lloyd's Managing Agent, and subsequently, Managing Director of an operating division of […], before becoming in 2010 a consultant with […]a provider of business advice and IT solutions to the insurance sector. The second expert report dated 1 September 2017 was from Mr William McConnell FIA, a qualified actuary for 31 years. From 1993 to 1998 he was general insurance actuary of […], and then Chief Actuary for […] at Lloyd's, the owner of […] and […], both motor insurers. In 1999 he was appointed to be the first Lloyd's Actuary, guiding, monitoring and regulating actuarial reserving in the Lloyd's market. He joined the […] in 2002, retiring in 2016 but retaining the role of Chief Actuary for regulatory purposes.

110. There were also two expert reports on behalf of KPMG, Mr Taylor and Mr Hulse. The first report dated 1 September 2017 was from Mr Stuart Wilson, a chartered accountant since 1995. He became a partner in […] in 2009. Since 1992 he has had extensive experience in the auditing of insurance enterprises, in particular the auditing of domestic general insurance and life insurance companies, including those operating in the Lloyd's market. The second report dated 1 September 2017 was from Mr Alex Lee FIA. He is a qualified actuary and since 2003 an executive director of […]. His work has included actuarial support for […] external audits in respect of several Lloyd's syndicates, as well as providing SAOs for Lloyd's syndicates, including some syndicates with motor insurance portfolios.

111. On 29 September 2017 Mr Collier and Mr Campbell served further reports in reply, respectively, to the witness statements of Mr Portsmouth and Mr Wilson, and on 20 October 2017 there were also served Joint Expert Statements from those witnesses.

112. Executive Counsel did not serve any witness statement from an expert actuary.

113. The agreed documentation in this case was voluminous, running to over 40 bulky lever arch files.

114. The hearing before the Tribunal extended to 4 weeks, from 27 November 2017 until 21 December 2017. For the hearing, each party served extensive written opening submissions. The witnesses mentioned above attended the hearing to give oral evidence, and each was cross-examined by counsel for the opposing party. Each party served detailed closing written submissions, as a basis for their closing speeches. On 20 June 2018 the Tribunal sent to the parties a draft Decision which set out the Tribunal's findings on the Allegations. That draft Decision was finalised on 20 August 2018 in the light of textual amendments proposed by the parties. A hearing was held on 16 and 17 October 2018, at which the parties made submissions on the sanctions that the Tribunal should impose in relation to the proven Allegations. On 14 November 2018 the Tribunal sent to the parties a draft Decision which set out the Tribunal's decision on the appropriate sanctions, and which was finalised in the light of the parties' suggested textual amendments.

C. THE EVENTS 2007-2010 IN MORE DETAIL

115. As we have already mentioned, the documentation in this case was extensive. A closer examination of some of the contemporary documents provides, in our view, a more penetrating and illuminating view of the events that have been outlined above. Accordingly, we set out below a more detailed description of the events in question, referring to the contemporary material and quoting from contemporary documents where we believe that it would be appropriate and helpful for understanding our treatment of the allegations made against each of the Respondents.

116. Mr Morgan was first employed in 1999 by ███ the managing agent at that time of Syndicate 218. Mr Morgan was promoted to Head of Finance in 2001 and to Director of Finance in 2003, Retail Underwriting.

117. On 26 September 2006 Mr Morgan became ESML's Finance Director. This appointment came at the time when significant changes were being implemented in

the claims handling processes (see paragraph 30 above). It was in the course of 2007 that a notable deterioration in the development of paid claims was observed. For example, on 12 September 2007 at the ESML Audit Committee and Board meeting, KPMG in its presentation stated:

> *"Over the course of the first six months of the year, development experience has deteriorated especially on the latest two accident years, resulting in an increase in the ultimate claims…."*

118. This perceived deterioration was the backdrop to the 2007 [...] Report (see paragraph 31 above).

119. KPMG, as auditors, were alive to the risks associated with these adverse developments. In its Audit Planning Document dated 1 November 2007, KPMG specifically identified as key risks:

    (i) Setting of RITC for the year of account and reserves for the open years of account, given the uncertainty attaching to this area following the needs of the group to make its profits target and meet its covenants.

    (ii) Pressure on management to return a result in line with expectations. The manipulation would come through the setting of reserves. Additional pressure was potentially given with [...] having taken over in January 2007.

120. On 19 December 2007 KPMG met [...], who accepted that "acceleration" of paid claims had occurred in early 2007, but did not accept that "leakage" had taken place.

121. On 25 January 2008 KPMG produced their Actuarial Audit Memorandum for Syndicate 218, stating that [...]'s conclusions were "not unreasonable"; and on 28 January 2008 presented their work to the ESML Audit Committee. On 30 January 2008 [...] made a PowerPoint Presentation to the [...] Board, regarding the claims handling processes, stating that he would seek to re-establish emphasis on costs management and controls. On 22 February 2008 there was a meeting of the [...] Reserving Committee, attended by Mr Morgan, Mr Utley (the Chief Executive Officer of ESML and the Group Chief Executive Officer of [...]), Mr Josiah and others, at which it was indicated that the matters referred to in the 2007 [...] Report had substantially been addressed. It was also noted that the 2006 and 2007 YOAs were still performing poorly in comparison with previous years, and that the ultimate loss ratio had increased to an unprecedented 79 per cent.

122. On 18 April 2008 [...] presented its Review of Syndicate 218's Technical Provision Report for Lloyd's year end reporting.

123. In 2008 file reviews were carried out in two exercises: one for the purposes of [...]'s year end reporting as at 30 June 2008; and a further file review towards the end of 2008, for the purposes of [...]'s half year and for Lloyd's 2008 year end reporting. These file reviews were not properly documented, although it is known from the email dated 2 December 2009 from Mr [...] that a total of £76.2m was removed from the case reserves.

124. In his witness statement Mr Morgan stated that he was not involved in setting the targets for the 2008 mid-year file reviews because he was at the time ill with swine flu. However, the contemporary documents show that Mr Morgan, as finance director of ESML, was closely involved with the mid-year case file review: see the email of 26 March 2008 from Mr [...] to Mr Morgan regarding the forthcoming file reviews,

and Mr Morgan's reply; and the exchange of emails on 24 April 2008 between Mr Morgan and [...] regarding the setting of targets for the mid-2008 file reviews.

125. Furthermore, the contemporary documents show that Mr Morgan, as finance director of ESML, was closely and actively engaged in the preparatory work leading to the end-June 2008 reporting, especially focussing on the continuing adverse paid claims development, and how that development would be likely to influence the ultimate loss ratio, a key element in [...]'s actuarial modelling: see, for example, Mr Morgan's email of 3 April 2008 replying to Mr Josiah; the email exchange of 2 June 2008 between Mr Morgan and Mr Josiah; the email of 2 June 2008 from Mr [...] to Mr […] and [...], copied to Mr Morgan; and [...]'s reply dated 3 June 2008, also copied to Mr Morgan. There is also no doubt on the contemporary documents that through 2008 Mr Morgan continued to press his case, to [...] and others, that "acceleration" and "leakage" were still material contributors to the disturbing trend in paid claims.

126. It is perhaps helpful, in the light of changes in [...]s's actuarial methodology at about this time from paid to incurred development, to explain briefly the nature of incurred claim development. "Incurred claims" represent simply the addition of paid claims and the case reserves. It is a hybrid function. It has an element to cover the settled claims (paid claims) and one for those which are still outstanding (the case reserves). Both paid claims and incurred claims functions must logically move towards the ultimate loss as development increases. Incurred claims development is a more complex function, based upon three assumptions: a stable pattern of claims settlement; a stable pattern of claim reporting, and, most importantly, <u>consistency in the setting of case reserves.</u> By way of simple example, claims of a particular class might have a typical 3-year "run off", with the period of "origin" being the year in which the risk was underwritten, and the consecutive periods being the "development" months. It would then be possible to track, for each development month, the total of incurred claims (paid claims and case reserves). For fully mature years the final total of payments at the end of the 3-year development will be known or reasonably capable of reliable estimation.

127. For claims in the process of development, it is not known how the total claims will develop, or what the total payments will be. However, it is possible to use past data of incurred claims to project an estimate of development and of the total amount expected to be paid.

128. The data is appropriately represented in a conventional table, having a "triangular" aspect, with each row representing a different period (for example, underwriting year) in which claims were incurred and each column successive "development" periods, the total claims to date being shown by the rightmost entry in each row. There are a number of actuarial techniques available to perform the projection, for example, "grossing up", "link ratio"/ "chain ladder" and "loss ratio projections". Projected total payments for a particular underwriting year can be compared with known total premiums for the related business, to yield an expected ultimate loss ratio.

129. Total payments to date, or total incurred claims, for a particular underwriting year can also be shown as a percentage of total premiums and compared with the percentage at that point of development for similar business in earlier years. Case reserves can be shown "gross", that is, discounting any amount recoverable by reinsurance arrangements, or "net", taking credit for any such amounts.

130. It is plain that the reliability of data, especially its consistency, for incurred claims is crucial; and that in turn requires reliability, especially consistency, in case reserves, which constitute an essential element of incurred claims.

131. It should be noted that in the amended Formal Complaint dated 21 April 2017 against Mr Rakow, Executive Counsel alleged that there was no reliable process in Syndicate 218 for ensuring that case reserving was carried out on a consistent and systematic basis from year to year and, in particular, there was no process for reviewing the accuracy of reserves on a regular basis. Executive Counsel referred in that context to case file reviews, alleging that the building up and subsequent release of "redundant" reserves served to obscure the real trends in changing claim costs. Executive Counsel further stated that, as a consequence of case file reviews, it would not have been possible for an external actuary such as Mr Rakow to track the development of individual case reserves or identify the processes adopted. Consequently, it was alleged, inconsistencies within the incurred claims data could not be identified and challenged or rectified by an external actuary, and there was a real risk that the impact of the case file reviews would be obscured by other claims activity.

KPMG's Audit of the 2008 Financial Statements

132. KPMG's audit of Syndicate 218's financial statements in both 2008 and 2009 followed the same pattern. Some planning work was undertaken and a presentation of KPMG's proposed audit strategy was made to the ESML Board. It was after that presentation that KPMG held what it called its internal "kick off" meeting, at which KPMG considered in general the appropriate and necessary steps for the conduct of the audit, and the broad scope and substance of the audit. In relation to the 2008 year, field work was carried out in late November /early December 2008, and included testing of samples of claims files.

133. On 19 November 2008 KPMG gave a presentation to the Syndicate 218 Audit Committee setting out KPMG's audit approach and timetable for the year ending 31 December 2008. Reserving was again identified as the factor giving rise to the highest risk of misstatement. Mark Taylor was identified as Engagement Director and Tony Hulse as Lead Partner.

134. On 27 November 2008 KPMG held its "kick off" discussion relating to the 2008 audit. It was especially noted that there was a *"need to consider potential for manipulation of results due to internal pressure"*.

135. On 28 November 2008 Mr [...] and Mr [...], audit managers of KPMG, met with [...], the claims director and head of claims at ESML. [...] said that, although "acceleration" of claims had occurred in the early part of 2007, he thought that deterioration in the loss ratios were caused mainly by "market issues".

136. On 28 November 2008 Mr [...] and Mr [...] of KPMG met with Ms […], the special risks underwriter. In contrast to [...], she felt that *"claims were hitting the books and being settled earlier than in prior years",* and believed, in the light of audit evidence, that *"quality [in settling claims] was suffering at the expense of quantity".*

137. On 2 and 5 December 2008, KPMG conducted tests of sets of 25 sample claims, the identified control being *"reserves should be set when claim informed to Equity and adjusted as claim progresses",* documented in audit Work Papers.

138. On 5 December 2008 KPMG met with Ms […], the claims site manager in […] (dealing with low value claims) who said, in contrast to Ms Cole, that she did not consider claims were settled quickly in an attempt to minimize the backlog; according to her, there was a big focus on quality and "leakage". Files were reviewed before payments were made; programmes were in place to promote accurate claims processing, and internal audits had been favourable.

139. On 12 December 2008 Messrs Taylor, [...] and [...] of KPMG met with Messrs Josiah and Morgan (KPMG Actuaries [...] and [...] joined by phone). KPMG's note records, among other things:

> *"New Claims Director brought in whose background is operational reporting in the direct market and is used to process driven claims process. Claims department feel that no major methodology changes have occurred since new Claims Director commenced. More focus on clearing back-logs rather than quality of claim and settling for the correct amount…*
>
> *…There is the possibility that claims are being 'processed' as opposed to being 'settled' and that payments on claims may have been higher than should/could have been as well as being paid sooner than has been the case historically.*
>
> *As an example, there is more paid development and less incurred development this year on accidental damage than at the same point last year, indicating claims settlement has accelerated by 30% to 40% when compared to 2007.*"

KPMG's planning document (at C.01-C.14A) summarised identified risks as:

> *"Setting of RITC for the year of account and reserves for the open years of account given the uncertainty attaching to this area following the needs of the group to make its profits target.*
>
> *Pressure on management to return a result in line with expectations.* ***The manipulation would come through the setting of reserves****. Additional pressure is given with the potential [...] takeover and the likely sale of companies within [...] group."* (emphasis added)

The Planning document also noted:

> *"The setting of reserves is highly material to syndicate 218's results, and is an inherently complex process requiring a significant amount of judgment and the use of external experts. The quantum of reserves may not reflect the full*

extent of the underlying liabilities and hence may be insufficient to meet losses as they fall due."

140. Towards the end of January 2009 there was real mounting anxiety concerning the work of [...] and the reliability of their calculation of reserves. Time was pressing, and [...] had produced no final report. Material produced by [...] needed explanation and there was uncertainty about the sufficiency of reserves. In an email of 27 January 2009 Mr Taylor spoke of [...] *"playing silly buggers"* (in not releasing their report) and of the KPMG Actuaries not having *"managed the process particularly well"*. At the suggestion that [...] might be brought au courant with the situation, and invited to assist, Mr Hulse in an email of 28 January 2009 was highly critical of the KPMG Actuaries for failing to warn him (and Mr Taylor) of the concerns regarding [...]'s work, pointing out that the level of mismanagement, involving an *"appalling failure of internal communication"*, would inevitably result in the dismissal of either [...] or KPMG.

141. On 28 January 2009, the Audit Committee met (with Messrs Hulse and Taylor) to discuss [...]'s best estimate. Mr Taylor distributed a paper *"Lloyd's Syndicates 218 and 1208...Salient features memorandum for [...] group reporting purposes and update on local reporting."*

142. The paper notes that *"[w]e [KPMG] have reviewed the central estimates as calculated by [...]'s and based upon the draft information reviewed we are content that the overall results would appear a reasonable basis for reporting. However we await their final report...until we receive this our work remains ongoing in this area."*

143. [...]'s presentation, also given on 28 January 2009, set out the methodologies it had adopted in deriving their net ultimate claims estimates. In particular, it was noted that:

> *"The net ultimate claims estimates for 2006 & prior are largely derived by incurred link ratio modelling.*
>
> *The net ultimate claims estimate for 2007 is a weighted average of two models based on the split of claims between AD and TP....*
>
> *The net ultimate claims for 2008 is based on the same ULR* [ultimate loss ratio] *roll forward methodology as adopted at our previous review."*

144. On 28 January 2009 [...], a KPMG actuary, in an email sent to [...], copied to [...], stated, inter alia, that the key ultimate loss ratio selections concerned the 2007 underwriting year *"not only because there is inherent uncertainty around this year... but because the 2007 ULR drives the ULR selection for 2008"*. It was also stated that [...]'s techniques were *"not unreasonable based on the key assumption that it is the recent management changes that are driving the change in case estimation and speed of payments."*

145. On 30 January 2009 [...] sent a further email following a conference call between the KPMG and [...] actuaries. [...] highlighted the changes in [...]'s methodology, the deterioration in performance, and the challenges presented by these developments.

> *"The methodology used by [...] from around 2004 to 2008 Q2 was the Motor Focus model which was effectively an incremental paid model which relied on consistent development of paid figures between underwriting years. However, in 2006 a number of management changes were made, including the appointment of a new claims manager who implemented measures to process claims faster and to settle earlier, which led to an acceleration of the paid development starting in late 2006 and continuing into 2007 and 2008. Hence the decision was made at 2008 Q4 to put more emphasis on the incurred projections as this development was seen to be more reliable.*
>
> *2003*
>
> *The deterioration in ULR* [ultimate loss ratio] *since 2008 Q2 (65.1% to 66.4%) has been due to a general deterioration in the incurred position. We will perform a high level projection to see if this suggests a reassessment of the level of savings coming through on later years is needed.*
>
> *2007*
>
> *We discussed with [...] the impact of price aggregators on their Private Car business... [...] felt that because of the speed of the incurred development...that any effects would be broadly captured within the data. The deterioration in the 2007 ULR since 2008 Q2 (80.1% to 82.2%) is driven by the claims experience. At 2008 Q2 the methodology relied on a ULR selection whereas the methodology at 2008 Q4 relies on the actual claims experience…"*

146. On 2 February 2009 [...], [...] and [...] sent their Actuarial Audit Memo as at 31 December 2008 to Messrs [...], Taylor, Hulse and […], a director of [...] in [...].

147. On 16 February 2009, Mr Taylor emailed Mr [...] (acting EQCR), attaching a draft presentation to the Audit Committee, noting that *"The real issue as always is around the level of reserves and ensuring consistency between years. Our actuaries are content that the basis of setting the central estimate by [...]'s is appropriate..."*. The following day, as recorded in a KPMG file note, Mr [...] stated that he was comfortable that KPMG had appropriately considered and dealt with the key risk areas identified.

148. On 18 February 2009 the Audit Committee, including Mr Morgan, met and approved the Syndicate 218 results. KPMG presented its Audits Highlights Memorandum, which stated that [...]'s central estimates were not unreasonable and said:

> *"Claims are higher primarily due to the deterioration seen on the 2007 YOA, which has been particularly affected by adverse claims development and changes in the internal claims processes which have resulted in increased claims leakage. Prior year run off, which has normally realised positive results have also seen greater adverse deterioration in the period than the longer term norm…*
>
> *We have reviewed the central estimates as calculated by [...]'s and are content that the overall results represent a reasonable basis for reporting. It should be noted that the key judgment is in relation to the setting of the reserves around*

the 2007 YOA, due not only to its immaturity but also unique factors which impact its performance (e.g. significant increase in private car business and the impact of changes made to the claims processes...) and the fact that the 2007 ULR's [sic] drives the selection of the 2008 ULR's [sic]."

Events in and concerning the 2009 Financial Year

149. In 2009 Mr Morgan directed that file reviews be conducted twice, first for the purposes of [...]'s year-end reporting as at 30 June 2009 and secondly, towards the end of 2009, for the purposes of [...]'s half year and Lloyd's year end reporting.

150. The file reviews conducted in respect of the mid-year reporting took place in February and May 2009. According to an email of 2 December 2009 from Mr [...], a claims manager in the large loss team at ESML, during the first half of 2009 a total of **£100,934,490** case reserves were released during the 2009 file reviews, broken down as explained in the email, as follows:

> *"Between end of Feb & end of May this year we removed the following,*
> *93-2000 YOA £656,182*
> *2001 YOA £1,007,588*
> *2002 YOA £1,608,618*
> *2003 YOA £3,726,540*
> *2004 YOA £7,033,430*
> *2005 YOA £14,000,827*
> *2006 YOA £17,062,678*
> *2007 YOA £17,000,023*
> *2008 YOA £13,512,939*
>
> *We started reviewing 2007 YOA mid Sept this year and 2005 & 2006 YOA from 14/11/09. Up to today we have removed the following,*
> *2005 YOA £3,177,424*
> *2006 YOA £4,404,260*
> *2007 YOA £17,743,981"*

It can be seen that in aggregate £73.39m of case reserves was removed in respect of the 2005-2007 YOAs. By the end of May 2009 over £48m of reserves had been removed for those years.

151. It is plain that intense pressure was brought to bear on claims handlers to achieve the targets set for these file reviews, as evidenced by the contemporary documents. The intensity of the pressure, and claims handlers' resistance, was measured by the extent to which those conducting the review were "squealing", no doubt in protest, about the nature and extent of what was required of them.

152. On 3 March 2009 Mr [...] head of claims at ESML, asked Mr [...], head of the large loss (bodily injury) team at ESML, how the review was progressing, to which Mr [...] replied, copied to Mr Morgan:

"2001 [YOA] done. Squeezed £1m. Now squealing. Can't get [£] 1.25 [m]. 2002 [YOA] underway."

153. On 10 March 2009, responding to an enquiry by Mr Morgan, Mr [...] reported:

"01 [YOA] – £1m taken out on review. Completed.

02 [YOA] – £1.592m taken out on review. Completed. [£1.608m was in fact finally removed, despite the earlier "high" decibel of squeals]

03 [YOA] – not yet completed but looking poor [in the event £3.72m was finally removed from the case reserves, despite the earlier "ear splitting" squeals.]*"*

154. On 18 March 2009 Mr [...] emailed Mr Morgan and Mr [...]:

"03 [YOA] completed. And 04 [YOA] all but 100 files.

May I call for a further conversation to discuss the level of the squeal factor please? (high on 01 [YOA] and 02 [YOA] and ear splitting on 03 [YOA] and *__worse still__* *on 04 [YOA]"* (emphasis added)

155. On 19 March 2009 Mr Morgan told Mr [...] that they needed *"to push for the targets"*. On 14 April 2009 Mr [...] reported to Mr [...], inter alia, that the 2005 YOA was *"2/3rds of way there* [to the target] *([£] 4.5 [m] of [£] 7.5 [m]."*

156. Later that day Mr [...] told Mr Morgan:

"We are making inroads, 03 [YOA] with […] contribution has achieved just over £4mil. 04 [YOA] is proving to be a challenge as approx 30% of the money is on r/l files which are well developed & almost impossible to amend estimates. With […]'s contribution we are at £7.5 mil.

[...] *is going back to look at 02 [YOA] & prior [this was an error for 2000 YOA and prior YOAs] to see if any of the short falls can be made up from there.*

We are confident the later years [2005-2007 YOAs] targets will be achieved.…

I think this form of management is becoming more difficult with each passing year and we should be considering alternatives."

157. In late April/May 2009 Mr [...] emailed Mr Morgan:

"… YE [year end] *review – update on progress:*

We will achieve the 23/5 [23 May] target date and amounts. You may want to note that on 03 [YOA] and 04 [YOA] we are having to use a lot more of the files than we hoped – this means that august and november on those 2 years [2003 and 2004 YOAs] may be difficult. 05 [YOA] and 06 [YOA] look ok."

158. On 15 May 2009 Mr [...] emailed Mr Josiah, the lead underwriter at ESML, and Mr Morgan:

> *"04 [YOA] & prior PG* [...] *and I found about a million [pounds]. 05 [YOA] forward are on course for revised target.*
>
> *I don't think we can do any more &* <u>*need to be realistic from now on*</u> (emphasis added)*."*

159. On 18 May 2009 Mr [...] emailed Mr [...]:

> *"2007 [YOA] complete. 2005 [YOA] complete.* [...] *is worried about 2006. It's only a couple of weeks since we went through and this is in the style of 2004 [YOA] [where the "squeal factor" had been worse than "ear splitting"] to go in to the same ones again (for the [£] 3.94 m looked for).*
>
> *Please consider…"*

160. On 19 May 2009 [...] met at a scheduled one hour meeting with Mr [...] and Mr Josiah to discuss *"claims handling"*. [...] made two brief and sketchy handwritten notes of the meeting. In the first note there is a reference to *"03 & Prior – pretty much there"* and *"04 – 80-85% complete"*, and in the second to *"03 & Prior 04 80-85% 05, 06, 07."*

161. On 2 June 2009 Mr Rakow and Ms [...] of [...] spoke by telephone to Mr Morgan and Mr Josiah. The handwritten note of the call stated:

> *"2000-2003 – all years are still complete*
>
> *2004 …*
>
> *Started During March, most of impact in April/May*
>
> *2005 – Review to be completed by December*
>
> *– Volume of claims that have all been through*
>
> *05, 06, 07 Surprised at how much prudence in reserves."*

162. On 22 June 2009 Mr Rakow and Mr [...] of [...] spoke again on the telephone to Mr Morgan. The one-page handwritten note includes a reference to *"File review for 2002, 2003"*.

163. There is a note of 30 June 2009 from [...] entitled *"Focus Methodology Notes – 2009Q2"*. The Note refers to case reserving, as follows:

> <u>*"1993-1999*</u>
>
> *These years have been set to date as in previous reviews – minimal incurred development in these years.*
>
> <u>*2002-2003*</u>

Equity informed us that they have been through an exercise to reduce outstanding claim reserves to best estimate. A similar exercise was carried out for the 1998 and 1999 years when they reached development quarter 12. After this point, outstanding claims for these years further reduced by approximately 5%.

We have assumed that the 2000-2003 years will exhibit a similar pattern and have assumed that current outstanding claims will drop by a further 5%."

164. Mr [...]'s 2 December 2009 email records that during 2009, every YOA from 1993 to 2008 was reviewed (even though 2008 was only in the second year of its development), and in total £34.7m of supposed redundancy in the case estimates was removed from the poorly performing 2007 YOA alone.

165. During July 2009 [...] was working on its Syndicate 218 Valuation Review as at 30 June 2009, prepared for ESML, and Syndicate 218 Valuation Report as at 30 June 2009, for the purposes of [...]'s year end reporting. The Review and Report were of considerable importance, particularly because there was the real prospect that any assumptions made by [...], and the methodology that it adopted, would be replicated in [...]'s SAO for Syndicate 218's 2009 YOA, prepared in early 2010 for Lloyd's reporting, and would be reflected in ESML's Annual Report and Accounts for the year ended December 2009. [...]'s thinking at this crucial moment is revealed in its final Valuation (dated 3 August 2009). At various points in that Valuation [...] emphasized "Key Areas of Uncertainty". Paragraph 2.9 of the Executive Summary, under that specific heading, merits substantial quotation:

"*There is always uncertainty in estimating liabilities for future claim payments in general insurance business. Particular issues specific to Syndicate 218 are set out below.*

For Motor Focus, changes in the speed of payment of claims and the strength of case estimates have given rise to significant changes in the paid claims development pattern shown by individual underwriting years. In making our estimates of the ultimate claims for the 2005 to 2007 underwriting years we have used the incurred link ratio method which gives a lower ultimate claims amount than would be derived using a paid link ratio model. If the paid development of those years was to follow that of earlier years, then this may lead to the crystallisation of model risk. <u>Basing our selected ultimates for 2005 to 2007 on incurred models is a key judgement.</u>

Following the aforementioned changes in the speed of payment of claims, Equity informed us that this had led to claims that would ordinarily be contested, to be settled quicker but for a higher amount. As such, the ultimate claims loss ratios for the 2006 and 2007 underwriting years would be higher than ultimately expected. However, going forwards, Equity has identified this issue and through changes in claims processes implemented during early 2009, will seek to remove this 'claims leakage'. In selecting our estimates for the 2008 and 2009 underwriting years we estimated 6% of the 2007 ultimate claims loss ratio is due to the claims process deterioration. <u>The 2008 and 2009 underwriting year ultimate claims loss ratios were calculated allowing</u>

for such a claims process improvement in future claim settlement. This is a key judgement and a major source of uncertainty.

Equity carried out a review of redundancy in claims reserves for the 2000 to 2004 underwriting years of account. We have relied on the judgement of Equity for the amount of the claims considered redundant. There is a possibility that the size of the case estimates considered redundant is inaccurate due to the judgment involved.

Equity has carried out such a file review before in 2000 and 2001, specifically for the 1998 and 1999 years of account. In estimating the Focus claims ultimates for the 2000 to 2004 underwriting years, we have considered the final position relative to the incurred position at the time of completing the file review for the 1998 and 1999 underwriting years. There is a risk that the implied savings from the file review in these earlier years is not similar to the saving following the latest review. In addition, our estimates in May 2009 required a projection of the completed file review position for case reserves for the 2004 year of account. For this, an assumption was made such that the claims reduction for redundant claims is carried out evenly over the valuation period. This assumption may not be accurate, and as such leads to some additional uncertainty….” (emphasis added)

166. During July 2009 the KPMG Actuaries were naturally informed by [...] of the work that they were carrying out, the assumptions that would be made and the methodology adopted. Although they had not yet received [...]'s final Valuation, KPMG Actuaries did produce, dated 21 July 2009, a "DRAFT Actuarial Audit Memo as at 30 July 2009" for Syndicate 218. The draft stated, under "Executive Summary and Conclusions":

"Based on our discussions with James Rakow and [...] *from [...] and high level checks on the claims reserves, it is our view that:*

the methodology and assumptions made by [...] to calculate the best estimate reserves are not unreasonable…"

167. Notwithstanding the foregoing provisional conclusion stated in the draft Actuarial Audit Memo, it is clear from the contemporary documents that during July 2009 both the KPMG Actuaries and the wider audit team were having real concerns about the work done, and judgements made, by [...].

168. On 21 July 2009 [...], a senior manager in KPMG's risk, actuarial and regulatory department, emailed Mr Morgan, copied to Messrs Hulse and Taylor, and to three further members of the KPMG audit and actuarial teams, asking questions

"... caused by the changes to claims manager and approach in 2006 and 2009 which while probably highly appropriate in overall management strategy do have the impact of changing claims development patterns. As an offshoot from that, [...] have a [sic] made an assumption about the likely claims ratio from 2009 business. In this highly competitive market I thought the most informative manner of testing that approach was to ask:

What loss ratio do you target when underwriting new business for Motor Focus...

Have there been any significant changes in the sales channels....

Have you made any material alterations to the terms & conditions…"

169. On 24 July 2009 [...] emailed Mr […], director of KPMG Actuarial Australia in Sydney, copied to Messrs Taylor, Hulse, Brealey, [...] and [...], noting that:

> *"[...] will be showing the estimated impact of higher than 3.5% for annual claims inflation in their draft report...Somewhere between 5 – 7pc for an aggregated book would therefore sound more reasonable as an overall assumption…*
>
> *I've discussed with [...] their understanding of Equity's timing and intensity of the historic claims review process.*
>
> *I'm told to greater or lesser degree it happens in the last quarter of each calendar year. However they have carried out 2 more intense reviews of open claims, one was relating to 1998/9 years of account some while ago, but more recently they reviewed 2000/04 files.*
>
> *This has been carried out during the last 6 months with the 2004, the effect coming through as late as June 2009. It is understood they are trying to move to best estimates. <u>The effect of this will be to greatly diminish the extent of negative IBNR available going forward but also leave us with only limited belief in the patterns of incurred claims development data."</u>(*emphasis added)

170. In response to [...]'s email, on 26 July 2009 Mr Hulse wrote *"Based on these answers, I do not understand how you can be satisfied that [...]'s view is reasonable, as you implied in your audit sign off memo* [a reference to the Draft Actuarial Audit Memo dated 21 July 2009]*."* [...] responded:

> *"Whilst 3.5% is on the low side I continue to regard the [...]/Equity reserves as not unreasonable. Hence I support you providing sign-off... Experience with this account is that reserves have been progressively released. A major component of the reason for those releases is the strength of the case reserves held. We need to review all assumptions together when testing a reserving basis. The progressive reserve releases have demonstrated the basis is sound in conjunction with the case reserving policy. The claims inflation assumption coupled with all other assumptions to reserving is likely to produce a not unreasonable outcome. That is the reason for my continued support to sign-off."*

171. On 29 July 2009 there was a meeting of the Audit Committee of ESML. Those attending the meeting included Mr Morgan, Mr Josiah, Mr Hulse, Mr Taylor and [...]. Mr Rakow of [...] joined the meeting, to present the [...] Syndicate 218 Review as at 30 June 2009. Mr Rakow commented that, as regards methodology, *"[t]he challenge is if redundancy claims are not being tracked appropriately then this will result in an outward movement in Years of Account i.e. 2007"*. He also referred to an assumption

that later appeared in clear terms at paragraph 7.3.3. of the final Valuation Report, that merits full quotation:

> *"File Review Completion Assumption*
>
> *For those years that are in the process of the file review but not yet complete, an assumption was made on the future reduction based on the reduction to date.*
>
> *The file review for the 2004 year of account was incomplete as at 31 May 2009* [although by 18 March 2009 all but 100 files had been reviewed, in a process characterised by a "squeal factor" that exceeded the level of "ear splitting"]. *We have assumed that the reduction in case reserves since 31 March 2009 will display a constant trend until 30 June 2009, when it is expected to be completed. Therefore, we have assumed that the incurred reduction since 31 March 2009 was two thirds complete as at 31 May 2009.*
>
> *Finally, the adjustment of a 5% Savings Factor was applied to the case reserves after the adjustment of the file review assumption and the £2m described above was made."*

172. KPMG also presented at the meeting of the ESML Audit Committee its *"Audit highlights memorandum for the year ended 30 June 2009"*, based upon the work undertaken for [...] year end reporting. The memorandum stated that KPMG had reviewed *"the central estimates as calculated by [...] and are content that the overall results represent a reasonable basis for reporting."* Under *"Key areas of uncertainty"* the memorandum noted in particular:

> *"The level of negative IBNR* [that is, the amount of <u>release</u> from reserves], *of some £170.3m on a net basis ... is based upon the expected level of redundancy that exists within the case reserves held. The level of redundancy is heavily biased on historical evidence of redundancy realised and claims reviews carried out by management. Therefore, there exists uncertainty over the level of estimated redundancy in the case estimates*."

173. On 3 August 2009 [...] produced, for [...]'s year end, its final "Equity Syndicate Management Limited Syndicate 218 – Valuation as at 30 June 2009". Shortly thereafter, on 6 August 2009, KPMG produced its final Actuarial Audit Memo as at 30 June 2009 in respect of Syndicate 218. Like the Draft of 21 July 2009, the final Memo recorded:

> *"Based on our discussions with James Rakow and* [...] *from [...], our review of [...]'s draft Syndicate report* [the final Valuation as at 30 June 2009 was of course then available] *and high level checks on the claims reserves, it is our view that:*
>
> *the methodology and assumptions used by [...] to calculate the best estimate reserves are not unreasonable."*

174. Further file reviews at Syndicate 218 began in mid-September 2009 (for the 2007 YOA) and on 14 November 2009 (for the 2005 and 2006 YOAs), prior to the 31 December 2009 year end.

175. Mr [...]re-joined ESML in December 2009, having previously been ESML's Finance Director during 2005 – 2006. He raised concerns with the ESML Board and KPMG regarding the deterioration in Syndicate 218's cash flow position and stated that he was concerned that ESML, KPMG and [...] might be failing to properly recognise an underlying deterioration in the strength of the Syndicate's case reserves.

176. On 2 December 2009, responding to an email from [...], who had been an actuary at [...] from 2003 and became [...] chief actuary on 12 October 2009, concerning file reviews, Mr [...], the head of claims at ESML, said in an email copied to Mr Morgan:

> *"Since June [2009] the focus of the review has been the 07 year of account, no work has been undertaken on 05 & 06 [YOAs]."*

177. Later on 2 December 2009 Mr [...], a claims manager at ESML, emailed Mr [...] setting out the reductions in case reserves that resulted from the file reviews in 2008 and 2009. Regarding the latest file reviews, Mr [...] said:

> *"We started reviewing 2007 YOA mid Sept this year [2009] and 2005 & 2006 YOA from 14/11/09. Up to today [2 December 2009] we have removed the following:*
>
> *2005 YOA £3,177,424*
>
> *2006 YOA £4,404,260*
>
> *2007 YOA £17,743,981"*

178. Subsequently that day Ms [...], an actuarial analyst at [...], emailed Mr Rakow on the subject of "Focus File Review":

> *"I just had a quick call from* […] *who had spoken with Douglas [Morgan] and [...] [sic] on the file review. The attention was focused on the 2007 year only. It was business as usual for 2004 to 2006, if there was any notification of deteriorations then this was allowed for but there was no action to review case estimates downwards.*
>
> *I mentioned the high settlement activity on 2004 and asked for clarification on how far 2004 was taken to best estimate at 09Q2 [that is, end June 2009]. We have a call with [...] on Friday so hopefully we can get some clarity on any other questions we have on this."*

179. Finally, on 2 December 2009, [...] emailed Mr [...], copied to Mr Morgan, on the subject of "2004 Large Claim movements":

> *"Taking 2004, and looking at all the claims (between £130k and approx £1m), one can see that a relatively large number have seen the incurred increase and being settled since June [2009].*

Can you think of what would drive this?

Is this something which you believe is out of line compared to previous years? If so, any reason for this?

I am actually getting at trying and understand *<u>why this wouldn't illustrate an underlying under-reserving, especially after the June [2009] claims review undergone</u>* (emphasis added).

I attach a file with that data and the info is on the tab "Regular large" (between £130k an approx £1m)…."

180. Next day, 3 December 2009, Mr [...] responded that he thought that the approach to the review exercises had been consistent with previous years. A few minutes later, at 6.52am Mr [...] sent [...] a further email, attaching Mr [...]'s email of 2 December 2009 regarding "Strategic Review", with the message:

"Not sure if this helps as the numbers do not reflect what's happening in the rest of the dept were [sic] the handling is business as usual.

We do not have records prior to these."

181. On 4 December 2009 there was a conference call between [...] and Mr [...] and Mr Rakow and Ms [...] of [...]. Various, sketchy, notes were made of the call. Ms [...]'s note simply states *"looking at 2007 … 05 + 06 not really looked at"* and *"2005 + 2006 not at best case."* A further note records Mr [...] as saying that there was a *"[r]eview exercise mid year",* which looked at older years, especially the 2007 YOA. Asked by Ms [...] whether *"05, 06"* were *"looked at",* Mr [...] replied that there had only been a *"[g]eneral review"*. Asked by Mr Rakow about the *"level of scrutiny"* in the *"run up to Xmas"*, Mr [...] replied *"05,06 less so than last year."* Ms [...] remarked that she knew *"2000-2003 review to take down to B/E* [best estimate]", and Mr [...] said that review estimates were *"reasonable for 05-06"* so far. Ms [...] later remarked that *"05-06 noticed no large movt"*, and *"[e]xpected downward at this time of year from file review."* Mr [...] responded *"05-06 no review to take reserve savings"*. A third note simply states *"05,06 less so."*

182. At about this time [...], an experienced actuary and partner, joined the KPMG team working on Syndicate 218's reserves.

183. On 21 December 2009 Mr Rakow and Ms [...] attended a working session with [...], and consideration was given to a "virtual file review" of large claims for 2005 and 2006 YOA. During the meeting, at [...]'s request, Ms [...] sent an email to Mr [...], head of claims at ESML, with a list of claims for his team to review. Ms [...] stated in that connection:

"we are after your thoughts on whether the current level of outstanding claims are likely to be paid and by how much. In the current estimates we assume that these claims will not have any savings on them. Your thoughts would be useful to understand if there is any scope for savings in these claims."

184. Later that day Mr [...] emailed the results of the virtual file review. 19 large claims for 2005 and 2006 YOA had been reviewed, purporting to show a total substantial "redundancy" in case reserves.

KPMG's Audit of the 2009 Financial Statements

185. On 18 November 2009 KPMG gave an Audit Strategy and Planning presentation to the ESML Audit Committee, identifying reserving as the most significant audit risk and noting:

> *"Reserving is the most significant and judgemental area of the financial statements. The assumptions made will have a material impact on the financial statements and the results for the year and the process will involve significant actuarial input and judgement. Syndicate 218 – although a consistent methodology has been used for some years now in formulating the central estimates, there are certain issues which will influence the level of results including: Market and external developments; Changes in underlying business mix; Changes in the reinsurance retention; and Settlement patterns and the impact of changes made to the claim process."*

186. A number of KPMG audit work papers are dated 18 November 2009, some are "walkthroughs" of a single claim, others document tests of sample of claims and identify the control as *"Reserves should be set when claim informed to Equity and adjusted as claim progresses"*.

187. On 25 November 2009 KPMG held its Kick-off discussion in relation to the 2009 audit. Mr Taylor was listed as RI. It notes in relation to Syndicate 218 that *"claims is a key area for the actuarial review and a key area of audit focus. There has been a change in claims management style from efficient processing to pay as little as possible which should show the IBNR credit being reduced."* It also stated under "fraud risks" *"Potential management incentive to improve results given group position. Reserves is key are [sic] of judgment so a risk but this is reviewed by actuarial."*

188. On 26 November 2009, Messrs [...] and [...], members of the KPMG actuarial team, met with Mr [...], head of claims at ESML, who stated that the policy of settling early had been changed, tighter controls over claims settlement to reduce leakage had been implemented, the reserving methodology had not changed and he considered the reserves were still conservative. Mr [...] also noted that he thought accidental damage and third party property damage claims costs were increasing, the main driver being expenses, but that ESML could not track the number of claimants per claim and therefore did not know if claim costs were likely to rise on open claims as a result.

189. The problems at Syndicate 218 were now receiving wider attention. On 13 December 2009 Mr [...], audit partner for [...] Group, emailed Mr Hulse concerning [...]:

> *"There was some discussion at the recent Group ARMCC regarding the UK performance and in particular the status of the 2007 u/w [underwriting] year in S218, <u>specifically the risk of it being the first year that an underwriting loss has been posted</u>. This has some heightened focus given reputation etc which <u>I am sure that you are alert to from an audit risk perspective</u>. Just wanted to give you the heads up that it was receiving some Group level attention* (emphasis added)

190. Mr Hulse responded the same day, referring to his lunch meeting with Mr [...]the preceding week:

> "[...] *'s big point was that he was concerned about the lack of cash float and the scale of cash outflow in recent years. Cash is much lower than when he was last at Equity and by reference to comparative metrics for Highway. He thinks it means that reserving is light and that Equity has been given the benefit of the doubt on changes to claims processes and their reserving implications when they should perhaps not have been. However it is early days at present. I took his concerns very seriously. We will see when [...] come back with their report."*

191. Mr Taylor, who had been copied in with the emails, intervened in an email later that evening:

> *"I spoke to Douglas Morgan late on Friday. We had an on the/ off the record conversation about closure of the 2007 YOA. Your understanding is spot on in that they are going to struggle to close at a positive result, but have a "40 year track record on the line", and will be doing everything they can to keep it. We had already identified this a [sic] a significant FS assertion risk at planning and I briefed the team Friday evening on my conversation.*
>
> *In light of* [...] *'s comments to Tony and me on Monday around reserving it is clearly going to be an interesting, and I'm expecting difficult, process around the December reserving numbers…"*

192. KPMG audit work paper for the period end 31 December 2009: Planning document – purpose, signoff and applicability (C1.01-C1.20) was dated 5 January 2010. As in the previous two years, its stated purpose was to document KPMG's: understanding of the entity's business and environment, its accounting policies and practices, and its financial performance; assessment of risks of material misstatement relevant to the audit, including error and fraud risks; audit strategy in response to these risks; and planned audit approach for significant accounts and disclosures. In particular, the document noted that:

(1) Given that the result of the closure of the 2007 YOA at 31 December 2009 was likely to be marginal, *"We must therefore act with increased suspicion and acknowledge the risk of manipulation on closing the 'Pure' 2007 YOA will be high this audit."*

(2) *"The expectations of [...] are high, especially in the current climate with [...] Group under pressure from its own* […] *shareholders to perform, there is a risk that they could exercise influence on the level of returns ... This could be by reserving...*"

(3) *"Setting of RITC for the 2007 year of account and reserves for the open years (2008 & 2009) of account given the uncertainty attaching to this area following the needs of the group to make its profits target, and for the 2007* [hand amended from 2006] *YOA to close with a positive result."*

(4) *"Pressure on management to return a result in line with expectation, particularly 2007 YOA which may not return a profit for the first time in S218 history. The manipulation may come through the setting of reserves."*

193. On 5 and 6 January 2010 Mr [...], a director of […], emailed [...] of the KPMG actuarial team, identifying material issues in relation to the [...] audit, saying, in two emails:

> *"I think the main issue is around the credit taken for "savings" on case reserves. I'll also talk to my […] colleagues to see if there are any other areas concerning* [...],
>
> *[...]*
>
> *The other area that has been identified is the very high paid and incurred development for U/W year 2007 relative to other years (at the same point in development) and is looking like it could potentially result in an underwriting loss for that year (First time ever according to Equity), see what you think about this and what is causing this (could be a speed up in settlement but this doesn't quite tie up with the outstanding position) See what you think about U/W year 2006 as well,*
>
> *Secondly, [...] mentioned that Equity were seeing higher payment activity:*
>
> *(1) we should seek confirmation on whether this is true and*
>
> *(2) what is driving it, how have the actuaries responded etc.*
>
> *We had heard that the* […] *team had tightening up on the claims process during 2009..."*

194. KPMG audit work paper for period end 31 December 2009: Evaluation of External Experts (C6.01) was dated 12 January 2010. Five procedures were set out under "evaluation of external experts' work": *"Obtain and review [...] report for reasonableness and comments which may impact on the financial statements; Ensure consistency between data used by [...] and audited tb/figures; Engage KPMG Actuaries to review [...] work and obtain and review KPMG Actuaries report; Ensure consistency between data used by KPMG Actuaries and [...] Actuaries; Obtain a statement of actuarial opinion from [...]."*

195. On 13 January 2010 Mr Hulse emailed [...], the very experienced KPMG actuary who had been recently brought into the team, copied to Mr Taylor and Mr [...] of the KPMG audit team, and to the KPMG actuary, [...]:

> *"I met [...] [the in-house actuary at ESML] at Equity this afternoon. They are having a torrid time working out the 2007 reserves and it is possible that S218's 50 year record of profits may be broken. [...] are doing a lot of extra*

work and [...] and Douglas Morgan are challenging them all the way, but they both acknowledge the situation is not looking good. [...] particularly asked that we up the depth of our contribution and when I said that you were due to attend Friday's meeting with her and […] she was very pleased.

The message is therefore that you will need briefing on the issues at Equity and experience elsewhere of 2007. Equity has suffered heavy cash outgoing, especially for BI claims, and a change of claims handling which obscures the real experience. <u>Incurreds look OK but paid are ghastly.</u>

Please let me know if you are OK for this or would like the audit team as well as ███ to give you a briefing." (emphasis added)

196. On 15 January 2010 Ms [...] of [...] emailed [...], KPMG actuary, [...]'s draft results in the form of draft Appendices D and E.

197. On 15 January 2010, [...], Mr Morgan (via phone) and the KPMG core audit and actuarial team (Messrs [...], [...], [...], [...], Taylor, and [...]) met with Mr Rakow and Ms [...] of [...] to discuss [...]'s draft results. KPMG's notes record:

"1.1 Changes in methodology from Q2: ...Discussion had concerning the level of claims leakage and how this had decreased since 2008. Part allowance was made on the 2008 year of account and to a greater degree an allowance was made on the 2009 year. Allowance in the range of 6%.

Another allowance is made due to that Equity now perform a greater level of 'Realistic file review' to ensure that case estimates are set at a BE level. This was previous done on a 'Virtual file review' basis. Claims handlers have tended to add considerable extra prudence to case estimates, this has historically meant large recoveries – this is evident from the development graphs shown in the [...] report. Upon more senior claims handlers review the claims these are then revised downwards – this is the level at which [...] have set there ultimate. It can been seen that there is considerable movement in the incurred increasing it above the selected ultimate figure. However upon a subsequent file review then the incurred level falls back to the original level again.…

1.2 Motor Focus large negative IBNRs

These are a result of the case reserve estimates set by Equity, JR feels that as the RI retention has increased from 2000 to 2009 to approximately £1m, the case estimates have increased as claims handlers are more prudent due to the possibility of greater deterioration. Also using the 2004 and 2005 years of account, where RI retention is close to £1m, as benchmarks for later year developments.

1.3 Claim Settlements

2006 claims handling changes were implemented which sped up the payment of claims, however these are now being reversed and payments slowed down in order to reduce the claims leakage (the amount paid over and above the

ideal claims settlement value). This change has been factored in to the 2008 and 2009 underwriting year ultimates. This therefore means that the payment patterns from the prior three years will not be representative of the 2009 and 2010 years of account going forward."

198. On 20 January 2010, Mr [...], a KPMG audit manager, sent Messrs Hulse and Taylor a lengthy email reporting on a discussion with Mr Morgan held that day, saying:

> *"I had a good session with Douglas today after the call where we spoke about the pressures on the 2007 YOA, impact on future year of accounts by 'forcing' 2007 to be break even, and the journals posted for the balance sheet recs.*
>
> *The conversation was prompted by me showing him the table below... Essentially what this shows is that going into 2009, <u>the 2007 YOA was already running at a cumulative loss of £7.6m</u>.*
>
> *Douglas is hesitant about putting too much on paper but showed me an email he had sent to* [...] *explaining that they were currently 'short' on the 2007 YOA by some £6.9m. I did not see the response, if any, from* [...] *….*
>
> *In terms of other years of account, 2008 started with a loss but Douglas expects this to generate a return of 3-4% to names overall. 2009 is the headline year where Douglas expects profits to be around £65m across all years. Douglas commented that his view would be for the majority of the hit to be taken by the 2009 YOA….*
>
> *One of the factors which works in the favour of Syn 218 is the parity between names which exists (see table below). With levels at c99% the impact of essentially flipping profits between years would not appear to be unfair on the 2007 names.*
>
> *The real issue for Douglas appears to be with [...]. ...My take on his comments were <u>that he feels he has pushed [...] quite hard already and that they would be unwilling to budge much further.</u>*
>
> *I was able to speak to [...] before the call. Something which we discussed was the fact that it is becoming hard to review the numbers. Looking at the incurred position, which is essentially made up of paids and outstandings, we know that;*
>
> *a) paids have fluctuated so much and with assumptions for leakage it is hard to use and;*
>
> *b) the outstanding position can move through the various forms of file reviews which take place. An example would be that following a file review a senior claims handler may move a reserve downwards from £100k to £10k. The following day, new information may arrive at which point the junior claims handler would push the provision back up to £100k. A recommendation from George would be that we need some stability in these estimates.*
>
> *Leading on from this I discussed with Douglas that we are currently trying to pull together a score sheet of overs and unders based on the methodology*

remaining the same as prior periods and that this exercise was proving difficult. Douglas' initial comment was that [...] would be able to help with this to which my comments was; 'Could she do it?'. Douglas thought this was a good idea and has set [...] off on performing this exercise. Douglas has just come to see me and say that very rough numbers form [...] based on June methodology would show a £1.2m improvement, compared to [...] showing a £20m deterioration. Food for thought. …"(emphasis added)

199. On 21 January 2010 Mr Hulse replied to Messrs [...] and Taylor saying, *"Blindingly obvious but this is very dangerous territory. The road to perdition is paved with good intentions."* Mr Taylor replied to Mr Hulse: *"Let's get through group reporting, but clearly you and I and Rob need to agree how much we are prepared to accept them pushing."*

200. On 21 January 2010 KPMG prepared a presentation "Equity Syndicate 218 reserves at Q4 2009 - Actuarial Review". In relation to the Motor Focus 2008 accident year it noted that [...] had applied key assumptions including that the 2008 incurred claims would develop in similar fashion to 2007. It was noted that this was not unreasonable but that the 2008 ultimate *"is therefore extremely sensitive to the ultimate selection"* for 2007. Since it was hoped that the change in claims processing/settlement procedures at ESML would reduce claims leakage, [...] had reduced the ULR by 6% from 2007 in their Loss Ratio Roll Forward. KPMG had performed sensitivity tests on [...]'s assumptions but *"combinations of assumption changes may produce very different ranges of results"*. The [...] selected ultimate was £273.96m, or 75.9% as a ULR.

201. In relation to the 2009 accident year, [...] had also reduced the ULR by 6% from 2008. KPMG noted *"the 2008 selected ULR has already taken the potential savings from claims leakage reduction procedures in to account and that this therefore represents a year-on-year improvement of 6%."*

202. Several KPMG audit work papers are dated 22 January 2010 documenting tests of 25 claims:

(1) Large Loss PI Controls testing (N3005).

(2) Large loss PI controls testing (N3006).

203. On 26 January 2009 [...], Mr [...]and Mr Morgan and others for [...] and Mr Hulse and Mr Taylor and others for KPMG met to discuss the [...] half year clearance agenda. According to KPMG's note, Mr Taylor noted that *"paid claim development has not slowed down — continuing at quite a rate. It was noted that there a big judgements [sic] on slide 6 ... the changes made in claims process were accepted, although the numbers are not showing this yet"*. According to the note [...] said [...] would start on the December 2009 update shortly and she and Mr [...]noted that *"a lot of work was going in to understanding it all, that is, what the numbers were really showing eg whether paying more quickly, or more claims etc..."*.

204. Also on 26 January 2010 KPMG prepared slides for its "Actuarial Review" presentation The Executive Summary stated:

"... we believe that the reserves proposed by [...] are not unreasonable. We would draw attention to a number of uncertainties, particularly around the 2009 year of account and the 2008 Motor Focus year of account. Is [sic] our view that the best-estimate, or 'central estimate', proposed by [...] is at the lower end of the reasonable range of results which might be produced.

There have been a number of changes to claim payment processes since 2006. In 2006 a new claims manager was appointed who, by agreement with management, sped up the payment of claims which resulted in an increase in claims leakage; the sum paid over and above the fair value of the claim. At the beginning of 2009 new claims processes were introduced with the intention to reduce claims leakage which resulted in the slowing of claims payments. For this reason the development patterns of paid claims have not been relied upon in [...]'s analysis.

We note, however, that there is significant uncertainty around the incurred development pattern. Historically high outstanding claim reserves have been set which have resulted in negative IBNR being booked in the reserves. Periodically open claims will be reviewed by a senior claims handler and the case reserves reduced on these claims. It would aid forecasting of ultimate claims if case estimates were set on a consistent basis throughout the claims handling process to the point of settlement…

The Finance Director has indicated that any case reserves left after claims are settled may not necessarily be released, instead they are left on the system in order to smooth releases over time. This will distort the incurred development pattern and it would benefit the forecasting of ultimate claims if case reserves were released as claims were settled.

We do not find the methodologies and assumptions used in the calculation of risk margins, reinsurance bad debt, ULAE (future Claims Handling Expenses) and the discounting to be unreasonable."

205. The slides also noted that:

(1) Since KPMG's review as at June 2009 [...]'s methodology had changed.

(2) *"[...] have relied heavily on the incurred development pattern in order to ignore this variation in paid patterns... Equity employ a policy of reviewing open claims on older years of account periodically and reducing case reserves on these claims to what is perceived to be a 'best-estimate' basis. This process adds volatility to the incurred pattern and, due to both the timing of these reviews and the natural variation in the amount reserves are reduced by, adds uncertainty to the incurred pattern."*

(3) In relation to a graph showing the substantially faster development of the paids for the 2007, 2008 and 2009 years of account compared with earlier years, KPMG warned that if the paid patterns for 2007 and prior years were developing more rapidly because of a deterioration in claims rather than an increase in payment speed caused by claims leakage process changes, this could result in a significant increase in ultimate claims estimates.

206. At a 27 January 2010 Audit Committee meeting Mr Hulse and Mr Taylor presented extracts from KPMG's Highlights Memorandum for [...] reporting purposes.

207. In the presentation KPMG concluded that [...]'s central estimates were not unreasonable but there remained significant uncertainties in relation to the central estimates set for the 31 December 2009 reporting, in particular (i) changes made to the claims function and the impact it had had on the speed and development of claims payment patterns and therefore on the level of ultimate claims; and (ii) market trends seen in relation to severity and frequency of bodily injury claims, in particular the impact of economic conditions and claims farming and the impact this has on overall claims costs.

208. On 30 January 2010 Mr Hulse emailed Mr [...], KPMG audit partner for [...] Group, a copy of the highlights memorandum and an update on the [...] Audit Committee meeting.

209. On 8 February Mr Taylor emailed Mr Lewis, copied to Messrs [...], [...], [...] and Hulse, noting that the key focus in the Syndicate 218 audit had been on reserving due to the continued strong (i.e. adverse) trend in paid claims which had been expected to slow; that management did not entirely understand or accept what the data was showing them; that given the likelihood the 2007 YOA would break even at best and Syndicate 218's unbroken track record of profit might be at an end,, *"management has intense focus on ensuring the 2007 YOA is not loss making"*.

210. On 10 February 2010 Mr Hulse recorded in his notebook that *"On motor,* […] *[*[…], *ESML's in-house actuary] has developed good evidence around speed of payment of claims. [...]'s reviewing"*.

211. Mr Hulse made notes dated 15 February 2010 in his notebook, stating that

> *"Equity have now assembled quite good information to support rapid payment. It has removed uncertainty that might increase reserves in December. Now [...] are trying to see whether there is any room to bring down reserves. Team has started some work but team has not had totality of information...AC on 24 February. Need very strong papers.*

212. On 16 February 2010 [...] sent a draft of its "Equity Syndicate Management Limited Syndicate 218 Valuation as at 31 December 2009". Section 2.9 (under the heading "Key areas of Uncertainty") of the draft Valuation report stated the following regarding file reviews:

> *"… During the first half of 2009 Equity carried out a file review of redundancy in claims reserves for the 2000 to 2003 underwriting years of account and the results of this were reflected in the case estimates as at 30 June 2009. Our previous estimates relied on the judgment of Equity for the amount of the claims considered redundant. Equity had carried out such a file review before in 2000 and 2001, specifically for the 1998 and 1999 years of account. In estimating the Focus claims ultimates for the 2000 to 2003 underwriting years as at 30 June 2009, we considered the latest position relative to the incurred position at the time of completing the file review for the 1998 and 1999 underwriting years. There is a risk that the implied savings from the file review in these years is not similar to the saving following the*

latest review. For our current review we have held our estimates from our previous review. Therefore the above mentioned uncertainty remains embedded within our current estimates.

For our review as at 30 November 2009, Equity carried out a virtual file review ... of all outstanding excess claims in the 2004 underwriting year based on information available at the time of the review. We have relied on the judgment of Equity for the amount of the claims considered redundant…."

213. In respect of "Capped Claim Modelling", paragraph 7.3.1.2 of the draft report explained the modelling for 2004 and prior underwriting years, stating that a "Savings Factor" of 50 per cent had been selected for those years. As to 2005 and 2006 underwriting years, the draft report stated:

> *"We have used an incurred link approach to estimate capped ultimate claims for the 2005 and 2006 underwriting years. As can be seen from the incurred claims development of the previous years, it is usual for the* […] *team to review the outstanding claims during the fourth quarter of the year with a view to removing some of the redundancy within the case estimates. As at 30 November 2009 Equity informed us that this claim review process had not been undertaken for the 2005 and 2006 underwriting years.*
>
> *Therefore before applying an incurred link ratio model, it was necessary for us to project the latest incurred position to where it would have been if the claim file review had taken place. In order to do this we needed to estimate what percentage of the outstanding claims at the start of the quarter would have been identified as redundant had the claim file review taken place (the "Outstanding Redundancy Factor').*
>
> *An Outstanding Redundancy Factor of 28.7% was selected for the 2005 underwriting year and an Outstanding Redundancy Factor of 30.4% was selected for the 2006 underwriting year. These selections were made by considering the Outstanding Redundancy Factors for 2005 and 2006 achieved during earlier claim file reviews and also considering Outstanding Redundancy Factors from surrounding years……"* (emphasis added)

214. Section 7.5 of the draft report dealt with "Net Motor Focus Selections – 2008 Underwriting Year". Paragraph 7.5.1 ("2008 Methodology and Selections") stated:

> *"For the 2008 underwriting year we selected an incurred development percentage based on the incurred claims development. As at 30 November 2009 the 2008 underwriting year was 23 months developed. Equity informed us that at this point in time there had been no action by the claims team to begin a case-by-case review of the case reserves to review the level of redundancy in the estimates. However, Equity also informed us that such a review had begun for the 2007 underwriting year during development month 23* [that is, in November 2008]. *Therefore, we considered it appropriate to use development month 22 of the 2007 underwriting year* [that is, October 2008] *as the benchmark for the development and applied this at development month 22 of the 2008 underwriting year* [that is October 2009]. *Our assumption is that development month 22 was the most recent development period with a*

<u>*consistent case reserving approach for the 2007 and 2008 underwriting years*</u> *... "* (emphasis added)

215. On 18 February 2010 [...], an actuarial analyst at KPMG, prepared four KPMG actuarial work papers for period end 31 December 2009. Document A1A-A11A stated that overall [...]'s methodology was not unreasonable, but drew attention to a number of uncertainties, particularly around the Motor Focus 2009 and 2008 years of account, and noted that [...]'s best-estimate was at the lower end of the reasonable range of results.

216. Document F1A-F19B noted that KPMG Actuaries had *"carried out a high level review on [...] reserving methodologies across all classes. We have not reprojected any classes ourselves only relied upon [...]'s projections and the accuracy of the data provided in there [sic] tables."* It contained a table F6A of Syndicate 218's ULRs benchmarked against an average of five other motor insurers. It showed a reasonably consistent correlation of Syndicate 218's ULRs against the average for years 2000 to 2007 but then a marked reduction in Syndicate 218's ULRs for years 2008 and 2009, diverging from the average.

217. On 19 February 2010 Mr Hulse made an entry in his notebook of a discussion with Messrs [...], [...], Taylor and [...], including:

> *"1. [...] & Douglas have worked to demonstrate that paids have been accelerated on 2006 & 2007 over 2005 & prior year.*
>
> *2. DM now has moved from Nov. data to Dec. data. Initial view that Dec shows no improvement & therefore balance of judgment is towards increasing IBNR. However 1 supports at least no increase, maybe some reduction. James Rachet [Rakow] is willing to consider reducing ultimates, but don't know more.*
>
> *3. What [want] KPMG Actuaries to work through basis for any reduced ultimates*
>
> *4. TH [Hulse] asked that consideration should be given to any effect in 2008*
>
> *5. MT [Taylor] emphasised that we can disagree with [...]'s. TH [Hulse] said that must be very well justified.*
>
> *6.* […] *said have received some extra analysis. Not totally comfortable, but may resolve with [...]…*
>
> *8.* […] *has asked that Equity provide evidence that savings on 2004 & 5 are applicable to 2007. Movements in structure of book may indicate a difference."*

218. On 22 February 2010 Mr Morgan produced an "ESML Board Paper – S218 Financial Results 2009" which he sent to Mr [...]and other Board members at ESML, copied to Mr Hulse and Mr Taylor. Coincidentally on that day Mr [...], Group Actuary for [...] in [...], produced a note entitled "Syndicate 218 Valuation as at 31 December 2009". In the light of subsequent events, the concerns raised by Mr [...] at that critical moment do seem worthy of emphasis. They may be summarised as follows:

(1) The ultimate loss ratios selected by [...] for the underwriting years 2006 and 2007 were substantially out of line with, and lower than, that which would result from a projection from previous years;

(2) The ultimate loss ratios selected were also dependent upon case reserves being overstated by a factor of 3 – *"at odds with recent discussions about rolling file reviews and audits"*;

(3) Underwriting year 2004 and prior assumed a redundancy in case reserves of 50 per cent, a significant increase from the last valuation;

(4) 2005 and 2006 underwriting years *"have not had a file review"*. The [...] valuation assumed a material reduction in the case estimates, and based development methods on *"this reduced base"* – cause for concern *"given the question marks over case estimate adequacy in light of emerging experience"*;

(5) Even with the benefit of the doubtful assumptions regarding the 2007 underwriting year, the ultimate loss ratio selected for that year involved a "blend" with the value projected at 30 June 2009, when *"the somewhat tumultuous experience of the past six months"* opened up the earlier projected value to *"closer examination";*

(6) Every area of judgment that had been applied served to reduce the estimate of ultimate claim costs *"from a purer, but not necessarily appropriate, application of historical trends."*

219. Also on 22 February 2010 Ms [...] of [...] emailed Mr Morgan and [...] seeking a virtual file review of a sample of claims for the 2006 and 2007 underwriting years.

220. On 22 February 2010, [...] emailed [...] noting that it appeared [...]'s ultimates would be higher than they had been based on the November 2009 data, that [...], ESML's in-house actuary, had been working hard to justify a less extreme position and that:

> "*I detected a certain back tracking on the story of the changing claims managers. This was put over to me originally to say that they brought in someone to pay claims faster to avoid claims inflation. I next understood that they were detecting excessive claims leakage and so went back to the original culture of challenge and slower payment. Now [...] is saying (and this is interesting in that she worked for [...] not Equity at the time) that it was only challenge and not with the intent of slowing down the payment stream.*
>
> *Her current stance would allow her to claim that current high levels of payments are not indicative of a lot more to come, I expect her to say that they are simply emptying the bucket faster not dealing with the contents of a bigger bucket."*

221. On 22 February 2009 Mr Hulse also emailed Mr Morgan's board paper to Mr [...] and Taylor with three points to note: *"1 No risk margins so inconsistent approach. ... I would also like to understand whether [...] are recommending exactly the numbers Douglas [Morgan] has recorded and what the interpretation round them. 2 Important adjustment for claims handling between years of account. No explanation given. 3*

Other big entries between years – presumably the other adjustments we have seen on the spreadsheet ... need explaining in the AC paper."

222. On 22 February 2010 Mr Hulse made an entry in his notebook recording:

> *"Final reserves not yet available.*
>
> *[...] done review of £5k database*
>
> *Further work today & tomorrow*
>
> *1. Equity have identified savings. Historically savings were about 67% across all years on case reserves ... [...] accept this. The saving is by reference to the maximum point – not yet a single moment in time.*
>
> *2. .... 2007 is 18 months ahead of 2004. Changes in practice were implemented half way through 2006. Thus earlier u/writing years would not benefit much but 2007 benefited fully. The latest change is about control as opposed to slow claims payment.*
>
> *3. 2004 had file review, when old claims taken down. [...]'s have searched for inactive files, esp. those low level claims where strong probability of redundancy. ... 05, 6 & 7 have not had a pruning like 2004 had."*

223. On 23 February 2010 [...], ESML's in-house actuary, sent to [...] the results of the virtual file review for the 2007 underwriting year.

224. Later on 23 February 2010 Mr Rakow of [...] produced an "Explanatory Note for changes in Ultimate Claim Estimates between 30 November 2009 and 31 December 2009". Mr Rakow explained that his "best estimate" of reserves for the year ended 31 December 2009 which he had carried out in January 2010, was no longer his "best estimate". The level of "savings" assumed for the relevant year in January 2010 was higher than that assumed at 30 November 2009, and was not supportable given *"emerging experience during December 2009 and examination of certain diagnostics"*. The level of "savings" assumed as at 30 November 2009 was, therefore, re-instated, resulting, inter alia, in an increase in reserves of £4.7m in Motor Focus Net for 2007 and prior years, with consequential changes to the estimates of reserves for 2008 and 2009 underwriting years. Mr Rakow referred in the Note to the virtual file reviews (of 27 files for the 2006 underwriting year and 60 files for the 2007 underwriting year).

225. At 11.46pm on 23 February 2010 [...] sent the final draft Appendices D and E to ESML, which Mr Morgan forwarded to KPMG at 2.34am on 24 February 2010. At 4.51am Mr Morgan circulated a revised paper on the results of Syndicate 218. At 9.18am Mr Rakow of [...] circulated an email explaining [...]'s work. ESML's Audit Committee met at 9.30am. Mr Morgan was not recorded as present, but he was present at the subsequent Board meeting (at 11am), which was also attended by Mr Hulse and Mr Taylor. Mr Morgan's Report as Finance Director was tabled and subject to discussion, with Mr Morgan explaining the various adjustments to the accounts and key assumptions. On "Reserving" the minutes recorded:

> *"– having received a detailed key judgments paper from both Messrs Rakow and Morgan in relation to reserving, an in depth discussion and review of the*

> *content was held. Mr […] commented that [...] were still to provide their conclusions in relation to the key judgments and until such conclusions had been seen by the Board and KPMG, sufficient comfort could not be obtained to justify the reserves reflected in the results. It was agreed that a discussion needed to be held with Mr Rakow before the syndicate return could be submitted to Lloyd's…. The board concluded that an extension would need to be requested from Lloyd's in relation to the filing of the return preferably to Monday evening…"*

226. On 24 February 2010 Mr Morgan signed the "Data Accuracy Statement".

227. Also on 24 February 2010 [...] produced their final report "Equity Syndicate Management Limited Syndicate 218 – Valuation as at 31 December 2009". This was prepared in connection with reporting the half-year results for [...]; and was in materially the same terms as the draft produced on 16 February 2010.

228. Finally, at about 7pm on 24 February 2010 Mr Hulse emailed Mr [...], [...] Group audit partner:

> *"[...] came back last night with no substantive improvement in reserves from the position rejected by management late last week. ...The audit committee was not satisfied with [...]'s explanation of what they were doing - frankly there was not one - and has insisted that the basis of reserving is adequately explained and documented before they accept it. Equity has resigned itself to missing the Lloyd's solvency filing deadline."*

229. On 25 February 2010 [...], the senior KPMG actuary, emailed Messrs Taylor and Hulse copied to [...]. *"With [...] making such a pigs ear of the reserving* [for Syndicate 218]. *What views do you have about us pitching to unsettle them and become the providers of reserving and SAO work. From my perspective as auditors we are already on the hook so we may as well get paid more to be able to understand better."*

230. On 26 February 2010 [...] emailed Mr Taylor copied to Mr Hulse, [...] and others at KPMG raising questions about the 50% redundancy in old property reserves […]. Mr Hulse replied […] saying [...] must obtain his comfort from [...] and ESML, especially [...], ESML's in-house actuary.

231. On 26 February 2010 at 5.25pm [...] emailed [...] copied to [...], forwarding an email chain exchanged between [...], a KPMG actuary, and Ms [...] of [...] earlier that day in which [...] responded to various queries raised by [...] regarding Mr Rakow's earlier Explanatory Note. [...] pointed out that [...] was still assuming a 70 per cent "redundancy" on capped claims; and that the validity of this assumption had not been *"floated or explored on the material coming our way"*. [...] concluded that: *"It did look rather as if they [[...]] were scrapping [sic] the barrel and taking the wood too"*. *"Nothing has happened to improve the "look" of their Nov ultimates, quite the contrary matters look blacker. ...Not a satisfactory position and what if it looks much worse in 6 months or 12 months and we let it got [sic] through now, are we just storing up trouble for ourselves in the future?"*

232. On 1 March 2010, in the KPMG audit work paper "Evaluation of External Experts (C6) the boxes entitled (1) *"Obtain and review [...] [sic] report for reasonableness*

and comments which may impact on the financial statements"; (3) "Engage KPMG Actuaries to review […] [sic] work and obtain and review KPMG Actuaries [sic] report"; (4) "Ensure consistency between data used by KPMG Actuaries and [...] Actuaries"; and (5) "Obtain a statement of actuarial opinion from [...]" were initialled in the "done by and date" column.

233. On 2 March 2010 at 10.40am [...], the ESML in-house actuary, emailed to two KPMG Actuaries, [...] and [...], copied to Mr Taylor and Mr [...], attaching a summary diagnostic on savings achieved on open and closed claims. [...] then emailed [...] saying he had requested the detail behind the summaries.

234. On 2 March 2010 Mr Hulse spoke with [...] and, later, [...]. Mr Hulse's note of his discussion with [...] records:

> *"Review […]'s notes. Spoken to […]. Happy that know what has been done but not the judgment. … New December numbers reflect the reworking of same assumptions as November. Sampling factors: not sure how credible this is as a basis for a judgment. Doubts about November crystallised by continued adverse trend of savings. They didn't model savings at November. Gone down middle. If […] had re-projected, would have factored up somewhat based on adverse movement."*

Mr Hulse noted as key questions:

> *"1. Is methodology defective in base terms?*
>
> *2. Is adjustment now defective?*
>
> *3. If defects, how not known before*
>
> *4. How resolve?"*

235. Mr Hulse's notebook entry of his conversation with [...] records:

> *"8 weeks ago noted that S218 were lowering reserves wherever could<u>. Not maintaining consistency</u>. Could see blips in past. <u>Need to be skeptical [sic] about.</u>*
>
> *[...] seemed to be very high level. <u>SS doesn't think analysis is very realistic.</u>*
>
> *We emphasised consistency of claims setting. [...]'s change was to pay faster<u>. SS has sense of non-routine culling of estimates.</u>*
>
> *SS wanted to look <u>at two</u> samples & see how developed. Wants better detail to get comfort. Asked ███ to speak to [...] about her sampling.*
>
> *SS doesn't understand*
>
> *Methodology. Ok. However [...] took small sample <u>V worried about inconsistency of claims estimation No confidence in consistency SS said needed to test 50 files." </u>* (emphasis added)

236. Later, on 2 March 2010 Mr Hulse spoke again with [...] and [...]. Mr Hulse's notebook records:

> *"1. No changes of case reserving basis for bodily injury (over 35k). [...] says no more or less pessimism.*
>
> *2. No raiding of reserves for 2005-7. James R accepts need this representation. [...] confirms. 12 people in Brentwood doing claims long standing.*
>
> *3. Claims numbers development is only that – numbers – not projection of amounts. Just shows consistency.*
>
> *4. […] & [redacted] both think stratified samples needed. [...] had 48 hours – and that is why sample quite small. Chose 90 out of may be 6000. Stratified sample.*
>
> *5. JR thinks market deteriorating.*
>
> *6. November – comfortable at [...] level. Memo still valid Now recognise sensitivity of 2007 close*
>
> *i) Base: OK*
>
> *ii) Adjustment: v. sensitive*
>
> *Incurred still look good but utterly dependent of case est. methods not strong but not unacceptable".*

The use of the expression, "raiding of reserves", was especially telling: it vividly highlighted Mr Hulse's appreciation, and no doubt apprehension, that Mr Morgan might well, without adequate justification, use case file reviews to reduce case reserves by very substantial amounts, with a view to bolstering the Syndicate's results at a time when profitability was under serious threat.

237. On 2 March 2010 Mr Hulse spoke with Mr Morgan. According to Mr Hulse's notebook entry, Mr Morgan made the following statements:

> *"Changes to claims handlers – none except a little more prudent. Exceptionally cautious. Personnel changes*
>
> *[...] in charge*
>
> *[…] had no large loss team*
>
> *Smaller claims – [...] did affect AD* [accidental damage] *and small claims – accepted more liability.*
>
> *[...]'s primary impact has been settlement speed.*
>
> *Market info also better – better claims data to allow better understanding quicker. Also settlements.*
>
> *Small claims: 2 small AD done*
>
> *@36m – larger AD*
>
> *Small PI*

24000 total claims; 4000 left; vast majority are in 5k-25k

The process changes are v largely already factored in. Look at acceleration in paid settled

Still quite significant AD recoveries – subrogation

Sampling: [...] selected claims. Stratified by age. Independently done.

Virtual file reviews have been very successful – conservative by 5%. Demonstrated closely in past.

Internal virtual file reviews previously have been on larger claims.

DM has also done some random sampling.

Overall: looked at many more individual claims than previously. Worked much harder to filter differences of past and future, esp with all problems of timing

Better insight.

Consistency of claims is one of the strongest rep[resentation*]s can give."*

238. On 2 March 2010 [...] and [...] held a conference call with Mr Rakow and Ms [...]. KPMG's note of the call records:

"The notes relate to the Focus motor portfolio capped claims.

James stated his understanding that unlike the changes in approach and personnel we have seen in the loss adjusting process underlying own damage and TPD claims, the over £35k bodily injury loss adjusting process has continued unchanged even to the extent of the same personnel being involved year on year.

This has provided him with comfort that the savings patterns he has seen from the mid-1990's underwriting years, and [...]'s have relied upon for their analysis, will come through in all years examined to the current time. However some years have already released any material excess reserves and it is only 2005 onwards where further savings can be achieved.

James depends upon that consistency in historic development for the validity of his conclusions. The unit carrying out the reserving of the more financially significant claims only adjust those exceeding £35k, they are based in Brentwood.

The KPMG side undertook to challenge the Equity actuary [...] to gain support or otherwise for that consistency in the larger BI claims.

We are aware of lack of consistency by underwriting years as they hit different treatment in financial periods in the own damage and TPD loss adjusting over the years. This has arisen from different managers and practices over the period. We were concerned that Brentwood might have also been exposed to this affect.

James stated that there was limited scope for savings from the 2004 and prior underwriting years as a result of his understanding that these years having had their reserves reviewed and reduced close to expected settlement level already by Equity already.

However James understands that 2005/6/7 large bodily injury claims have not had their reserves taken down at all and he depends on this fact. Without it his analysis will not stand up he states.

We then changed to another topic. James took the view that his exercise of considering the progression of bodily injury claims by number in layered size bands was not strong enough to demonstrate a conclusion in its own right: but useful to indicate consistency with his findings seen in other aspects of claims patterns.

That consistency was shown to James' satisfaction. He therefore asserts that bodily injury claims on the books for a long period show a significant decline to settlement Amongst the many reasons for this is the practice of not assuming that shared responsibility will lead to financial benefits to Equity until it crystallises. James also relies on the loss adjusters involved not being influenced to change their practice by feedback that they are reserving above settlements. In fact the level is more than 3 times the level required. That is the implication of 70% release of reserves from their peak value.

The next topic brought up was James telling us his firm were given 48 hours to complete a sample of claims file review analysis. They selected 30 claims from 2006 and 60 from 2007 drawn as a cross section over the portfolio of claims, where no payments had been made for some time. The objective was to use a representative sample to compensate for the size of a sample not being as great as it might be.

James deduced from the sample that the November savings levels of the order of 70% were supported by the sample, but not more than that." (emphasis added)

239. Following their call with Mr Rakow and Ms [...], on 2 March 2010 [...] and [...] held a conference call with [...]. KPMG's note of the call records:

"[...] confirmed that the Brentwood large bodily injury unit has not changed in staffing or approach for many years.

She also confirmed that 2005/6/7 had not been reduced from the levels chosen by the loss adjusters in the large claim unit, whereas earlier years have been so reduced to more or less estimated settlement levels."

240. On 2 March 2010 at 6.32pm Mr Hulse emailed Mr [...], Audit Partner and head of insurance audit at KPMG, and Mr Lewis, audit partner and EQCR for the audit of the Syndicate, copied to Mr Taylor and Mr [...], stating that they had:

"reached a satisfactory conclusion on the reserving issues. Following discussion with [...], [...] and [...] are persuaded that an acceptable methodology had been used by them to determine the reserves for the purposes of the RITC of the 2007 YOA. Mark [Taylor] and I too have

discussed the issues with management and satisfied ourselves that the approach is acceptable. We expect to release our audit opinion on the Lloyd's solvency return tomorrow showing that the syndicate made a negligible profit for the 2007 YOA."

241. On 2 March 2010 at 9.40pm Mr Hulse emailed Mr [...] stating:

> *"... I should balance the books a bit. […] recognised the difficulty he was causing and when I met him this afternoon had thought through the judgements we needed to reach and how best to make them. He had identified a number of valid points and resolved them with his team and [...].... In this difficult case, we achieved a unity of purpose after some painful searching. So it would be wrong to call this another "nail"".*

242. [...]'s file note "Equity 218 Local Reporting Actuarial Sign-off (March 2010)" is dated 2 March 2010 (though was in fact backdated to 2 March as requested by Mr Taylor in an email of 30 March 2010, and draws largely upon the contents of Tony Hulse's email of 4 March 2010, below). It concludes that *"Overall it is KPMG actuarial's view that the [...] selected ultimates are not unreasonable"*.

243. In an email sent by Mr Hulse to Mr Taylor copied to Messrs [...], [...] and [...] on 4 March 2010 at 3.14pm, Mr Hulse said *"Given its significance, I note below the key points arising from"* his conversation with Mr Morgan on 2 March 2010:

> *"1 DM confirmed that there had been no changes to the exceptionally cautious approach adopted by* […] *handlers to the setting of case reserves for larger personal injury cases over the last few years. There had been very few changes in personnel involved. [...]'s new claims regime had not impacted in this area.*
>
> *2 As regards smaller claims, [...]'s changes had affected Equity's willingness to accept liability and pay claims, especially as regards AD and small Pl claims. These would have been generally settled for most of the years of account relevant to the closure of 2007 and prior by now.*
>
> *3 Speedier claims payments also resulted from market changes such as the receipt earlier of better data regarding the nature of the claim, again assisting rapid settlement*
>
> *4 DM quoted some statistics off the top of his head. Of 24,000 claims relating to the 2007 YOA, 4000 are outstanding, the vast majority in the £5-25k range. The process changes [...] instituted are already locked into those numbers.*
>
> *5 The main remaining action on many settled claims is the collection of subrogation, which is quite significant now. Several millions may be anticipated in recoveries from this.*
>
> *6 The virtual file sampling process referred to by [...] in their follow up report was conducted by Equity based on stratified sampling selected by [...]. The stratification was by length of time since last activity on the case. The file reviews were conducted by Equity staff and subject to review by [...].*

> *7 Virtual file reviewing is a process Equity have used in the past. The last time was for the [...] due diligence when a reserve number was determined with no "fat" in it; since then actual outturn has been about 5% better, good indication in Dam's mind that the claims handlers are good at estimating a no fat case reserve.*
>
> *8 Overall, DM said that many more individual files had been reviewed in connection with this year end's actuarial reserving. He was confident that Equity had a better insight into what was going on and that the results could therefore be relied on. He was very happy for the ESML Board to give a representation on the consistency of claims reserving.*
>
> *It is good to observe the consistency of these comments with the messages received from [...] actuaries in conversation with [...] and [...].”*

244. On 4 March 2010 at 3.31pm, [...] replied to Mr Hulse’s email stating: *“Many thanks for the attached which do resonate consistently with [...] comments as you say. Obviously one to watch but seems ok for now...”*.

245. On 16 March 2010 [...] emailed Mr Hulse and others, suggesting that no separate Actuarial Audit Memo was produced for Syndicate 218’s accounts sign off and stating:

> *“I attach our January deliverable for 218 which was part of the Group Sign-off. Regarding [...] role [sic] forward to year end for local purposes we did not produce a separate note, however [...] and the rest of our actuarial team reviewed the proposed [...] reserves and the circumstances surrounding them, following the December data becoming available to [...] and ourselves, and our conclusion was that we did not find them unreasonable and so were content to sign them off on that basis.”*

246. On 17 March 2010 Mr Hulse and Mr Taylor attended the ESML Audit Committee meeting. This was followed by a meeting of the ESML Board. Tabled at that meeting was a “representation letter”, in which the Board confirmed to KPMG that:

> *“the methodology employed by the Syndicate and its outsourced claims providers, namely,* […]*, in relation to the setting of case reserves both for bodily injury and larger accidental claims have remained consistent throughout the period from 2002. The board also confirms that the changes made to claims processes in recent periods have not impacted the case reserving philosophy or basis employed by claims handlers”*.

247. On 18 March 2010 Mr Taylor signed the 2009 SAA and SUYA. KPMG issued unqualified audit reports in respect of both.

248. On 30 March 2010 [...] emailed Mr Taylor an update to the KPMG actuaries’ 26 January 2010 Actuarial Review (dated 25 March 2010), which Mr Taylor asked him to date 2 March 2010, as that was when the conclusion was reached. In support of the KPMG Actuaries’ decision to sign off, [...]’s review set out in full the statements and representations given by Mr Morgan to Mr Hulse on 2 March 2010 as recorded by Mr Hulse’s email of 4 March 2010.

249. On 1 April 2010 Mr Morgan became Commercial Director at ESML, and at the beginning of April 2010 he went on holiday to the United States where he was when on 14 April 2010 [...] produced its final report "Equity Syndicate Management Limited Syndicate 218 – Review of Technical Provisions at 31 December 2009". The final report was in materially the same terms as the draft report for [...] reporting purposes of 16 February 2010.

250. On 1 April 2010 Mr [...], Group Actuary for [...] in [...], prepared an in-house actuarial analysis which concluded that the Syndicate's reported reserves for the 2006 and 2007 underwriting years were potentially deficient by £50m.

251. Mr [...]'s conclusion was supported by a further in-house actuarial analysis prepared by [...] on 14 April 2010, which showed a £50.5m deterioration in the reserves.

252. At a meeting of senior ESML and [...] management in [...] on 28 April 2010 Mr [...]obtained permission to commission an independent actuarial review to confirm whether the deterioration identified by [...] and Mr [...] was valid.

253. [...] and ESML decided to appoint a senior independent actuary, Dr […] of [...], to carry out an actuarial review on various bases. The formal terms of appointment were agreed on 7 May 2010.

254. It appears that even in late May 2010 [...] was uncertain about the timing and extent of earlier file reviews. In an email to Mr [...], head of claims at ESML, on 25 May 2010 she stated her understanding that the 2005 and 2006 YOA had been reviewed in April/May 2009, but not in late 2009; 2007 YOA had been reviewed (more heavily) in April /May 2009 and November 2009, and 2008 YOA had no review until April/May 2010. Mr [...] thought that her understanding was *"about right"*, although the heavier review of 2007 YOA was in November 2009; 2005 and 2006 YOA were reviewed also in November 2009; and 2006 YOA had also been reviewed during 2008 from *"April?May onwards"*. [...] forwarded that email to Mr [...], saying that the contents contradicted what Mr [...] had told her previously, that he had confirmed that 2005 and 2006 YOA were not reviewed in November 2009 and that:

> *"I don't know what has happened anymore."*

255. Dr […] produced her final report on 2 June 2010 (based on data to May 2010), which concluded that Syndicate 218's outstanding claims reserves as at 31 December 2009 had deteriorated by £212.5m from [...] best estimate at the 2009 year- end.

256. On 2 June 2010, in light of and accepting Dr […] 's analysis, [...] made an announcement to the stock exchange, recognising a one-off, pre-tax charge of approximately AUS$365m to reflect the Syndicate 218 claim reserve strengthening.

257. Dr […] carried out further actuarial work in July 2010, based on the data to 30 June 2010. On 10 August 2010 she published her final report to ESML concluding that Syndicate 218's outstanding claims reserves as at 31 December 2009 had deteriorated by a further £49m and were now, on a central basis, £261.9m worse than [...] best estimate at the 2009 year end (with a low to high range of £224.7m to £326.6m).

258. Dr […] 's work was supported by a separate actuarial analysis carried out by […] who carried out a review of a stratified sample of 398 open claims.

259. These events led to the Financial Services Authority commissioning an investigation by [...] under s.166 of the Financial Services and Markets Act 2000, which reported in March 2011, and to Lloyd's commencing enforcement proceedings against Mr Morgan and others, which culminated in Lloyd's censuring Mr Morgan, Mr Josiah, Mr Utley and ESML.

D. MR MORGAN

A. The Allegations

260. The allegations against Mr Morgan are reproduced at Annex A to this decision. In summary, it is alleged that:

(1) Between 2007 and 2010 Mr Morgan implemented a flawed file review process, which tended to undermine the consistency of the case reserve development data of Syndicate 218, in breach of applicable standards;

(2) Between 2007 and 2010, Mr Morgan failed to maintain an adequate standard of documentation in relation to the file review process, in breach of applicable standards;

(3) Between 2007 and 2010, Mr Morgan failed to ensure that the Board of ESML, [...] and KPMG were kept properly informed as to the nature and results of the file review process, in breach of applicable standards;

(4) Mr Morgan inappropriately persisted with, and increased the frequency of, the file review process, in breach of applicable standards.

B. Mr Morgan's Defence

261. In his formal defence Mr Morgan contested each of the four allegations made against him. In addition to his own evidence, Mr Portsmouth, an expert accountant with considerable experience of the Lloyd's market and Mr McConnell, an expert actuary also with considerable experience of the Lloyd's market, made witness statements and gave oral evidence at the hearing. Counsel for Mr Morgan submitted a detailed skeleton closing argument, with four appendices.

262. The principal points of Mr Morgan's defence may be summarised as follows.

263. Syndicate 218 was highly unusual, if not unique, in the Lloyd's market. From a time long before Mr Morgan became engaged with Syndicate 218, the Syndicate had adopted, and consistently applied, a practice of "exceptional prudence" in respect of

case reserves. The practice was undocumented, but case handlers, and others concerned with case reserves and reserving more generally, understood what the practice required, and adhered to it. In short, case handlers consciously overstated, beyond what would have been ordinarily "best estimate", the amount of reserve in respect of any claim. Accordingly, at any time, there was likely to be a significant extent of "exceptional prudence" or "redundancy" in the case reserves. Even if a claim had been fully settled and paid, an amount of "reserve" would for a time remain in the case file. Even if a case reserve had undergone a "file review" (see below), case handlers, given the opportunity on further review, would re-introduce an element of "exceptional prudence" in the case reserve. The foregoing practice also caused Syndicate 218 consistently to show in its annual accounts a negative figure for IBNR, indicating that in the final accounts the total of reserves had been reduced from the amounts appearing in the Syndicate's case reserve records. The relevant practice was well understood by all concerned; Syndicate 218 had been successful for 40 years, and the practice had caused no real problems regarding effective management or intelligible reporting.

264. In the light of the relevant practice, "file reviews" were entirely appropriate, indeed necessary. The file reviews were intended to reduce the case reserves, or at least some of the case reserves, to "best estimate" with a view to ensuring that the final reserves were closer to what Syndicate 218 might be expected in fact to pay on outstanding claims. Such file reviews had usually taken place in respect of a "closing" year, at the 33rd month of the 3-year Lloyd's cycle. The extent to which the case files were reviewed differed from year to year, depending upon the perceived point of the "underwriting cycle", a phenomenon described as "intensity" of review.

265. Accordingly, the "file review" process at Syndicate 218 was far from "flawed": it was an appropriate, indeed necessary, adjunct to the practice described above. In any event, Mr Morgan, as finance director of ESML, did not have primary responsibility for case reserving, or the adjunct file reviews: they were primarily the responsibility of Mr Josiah, the lead underwriter of Syndicate 218.

266. As to allegation (2), Mr Morgan accepted that no separate individualised record of any file review had been maintained. Nonetheless within the internal data system of Syndicate 218 the amount of adjustment following any file review would be properly shown, and in any event the incidence, and the broad result, of any file review could be detected from other material that was readily available to, and in fact considered by, those concerned with the process and results of case reserving at the Syndicate.

267. As to allegation (3), Mr Morgan contended that at all relevant times the Board of ESML, [...] and KPMG, were fully aware of the case reserving practice of Syndicate 218, and the adjunct process of file reviews. Again, despite the absence of exact particularised documentation, the incidence, and the broad result, of any case file review could be detected from other material that was readily available to the persons referred to in this allegation. If any of those persons wished to have further information, they simply needed to ask for it.

268. As to allegation (4), Mr Morgan accepted that the period 2008-2010 was a difficult one for Syndicate 218, in which there were a number of significant uncertainties, resulting, in particular, from changes to the Syndicate's internal claims handling, and from market developments both in terms of extent and amount of claims. However,

Mr Morgan was alive to the uncertainties, and took a view that he believed was supported by credible evidence, regarding claims development, and that enabled him, quite appropriately, to continue as he did with the process of case file review.

269. Furthermore, in respect of each of the allegations, Mr Morgan contends, first, that, even on the footing of any adverse factual findings that the Tribunal might make, he has violated no applicable standard; and, secondly, Executive Counsel has simply failed to produce expert evidence that is by law required to justify any such violation.

DECISION

Allegation (1)

270. We acknowledge that there is some force in Mr Morgan's description of, and reliance on, the historical practice at Syndicate 218. The exact nature and extent of "exceptional prudence" in case reserving at the Syndicate cannot be established with certainty. We were not shown any document that specifically recorded the practice, or any written directions to claims handlers that would have indicated how they were to go about the task of claims reserving, in particular, how, and to what extent, they were directed to apply "exceptional prudence" to that process. On the contrary, in his oral evidence Mr Morgan emphasised that individual case handlers were left to apply the "philosophy" of exceptional prudence in the way that each thought fit, and no two case handlers were likely to do it in the same way. He suggested that the introduction of rules, or a code, would have risked undermining its effectiveness, but we are not persuaded that that would have been the case. However, there was sufficient indirect evidence, including the incidence of negative IBNR, to indicate that some such practice had evolved and persisted for a substantial period.

271. Mr Morgan emphasised in this context that in 2000 and 2001 the 1997 -1999 YOAs had been subject to the hardest of case file reviews, where case reserves had been brought comprehensively to "best estimate". Nonetheless, he explained, the actual amounts of paid claims for the relevant years were less than the estimated reserves, evidencing very substantial "redundancy" in the case reserves that had originally been set. The results of the case file reviews of that period were well known to [...], who referred to their relevance in later reports. Mr Morgan stated that, from [...] point of view, the process of case file reviews was intended, in their language, to reduce "the funnel of uncertainty". In other words, assuming that there was a (putatively unknown) level of "redundancy" in the case reserves, file reviews would tend to reduce the estimated outstanding claims to an aggregate amount that would be closer to a "best estimate". That process would in turn facilitate [...] task of calculating the required reserves for the Syndicate. Given that at Lloyd's each year was a separate venture, fairness to names required that the final reserve figure should not be unduly prudent or deficient.

272. Neither Mr Portsmouth nor Mr Collier had encountered the relevant practice in their considerable experience of insurance markets. Mr Collier was especially critical of

the practice. He firmly believed that claims handlers should be instructed to value the amount of an outstanding claim only by "best estimate", having received appropriate guidance as to how "best estimate" should be applied to the claims in question. "Exceptional prudence" was a vague and uncertain concept, which claims handlers might well interpret and apply differently, carrying the potential for confusion and inconsistency. Indeed, as mentioned above, Mr Morgan accepted that within Syndicate 218 individual claims handlers did apply different case reserves to similar claims, and that there was no inherent thread of consistency to the process. Mr Collier believed that if something like "exceptional prudence" were to be applied to the amount of reserves held by an insurer, the process needed to be carried out as the ultimate step, in a clear and transparent manner, for example, by applying a well considered and agreed amount to the aggregate of the case reserves. Mr Portsmouth also said that, if profits were to be "smoothed" within the context of a Lloyd's syndicate, such "smoothing" ought ordinarily to occur only by transparent adjustment to the IBNR. "Profit smoothing" is essentially a process by which reserves are deliberately increased in a year when financial results are strong, with the result that profits are lower than would otherwise be the case, and reserves are deliberately reduced when results are weak, with the result that profits are higher than they would otherwise be. The outcome is a more even level of profits, which might be welcome to names, particularly if there is reasonable continuity in the composition of a syndicate. Mr Morgan fairly made the point that the Formal Complaint did not allege that any putative philosophy or practice of "exceptional prudence" in case reserving infringed any relevant standard or could constitute misconduct. We proceed on that basis.

273. Furthermore, given the historical nature of, and rationale for, case file reviews, as described above, we would not have concluded that they represented, without more, a breach of any relevant standard. However, in our view, the process of case file review at Syndicate 218 during the relevant period had the following highly objectionable features.

274. First, the ultimate aim of a file review was to reduce the case reserves by a pre-determined monetary amount. Executive Counsel characterised this amount as a "target". Initially, in his evidence Mr Morgan adamantly denied that he, or others, used that expression or that it was an appropriate description. However, he was later shown internal documents that referred to the amounts of reserves to be removed as "targets", and he then accepted that his earlier evidence was incorrect. This was one of several instances where Mr Morgan changed his position when confronted with relevant documents. This gave us serious concern in accepting evidence from him that was not confirmed by other witnesses or corroborated in contemporary documents.

275. In any event all case files were occasionally reviewed with a view to bringing the aggregate of case reserves to an amount believed to represent "best estimate". It appears that in 2009 "targets" were set for the comprehensive case file reviews of the 2000 – 2004 YOAs. Such a comprehensive file review does not appear common or even typical. It appears that generally the file reviews were labelled "low", "medium" and "high", terms expressing increasing amounts that would be removed from the case reserves. As already noted, the precise criteria that were employed in respect of any file review were wholly undocumented, and a description of the process is essentially dependent on Mr Morgan's evidence:

"In order to reach the target or buffer figure, I had regard to the management information for the Syndicate that was updated once a month.…

a. Firstly, I reviewed the historical triangulations going back to 1993. I looked for years that were similar with the present year. I then reviewed the percentage loss ratio impact that the previous reviews had resulted in, and ensuring that those past reviews were still showing surpluses in the claims development. This enabled me to assess what loss ratio impact had been produced by the previous file reviews in similar years and to check the subsequent claims development of those years. The aim was to remain consistent with historic file reviews. Like years had to be treated in like ways in order not to introduce inconsistency;

b. Following discussions with the Active Underwriter to agree the intensity of the next review this would be converted into a broad loss ratio impact. For example, if the prior period had been medium intensity and resulted in a 3.5% loss ratio improvement, and we had agreed that the next review would be hard intensity, that would be a 4% -5% improvement. This was never intended to be an exact figure. At best it was an estimate;

c. This was then multiplied by the premium to give a target figure (as a loss ratio is claims divided by premium, to convert a loss ratio into a monetary amount you have to multiply it by the premium to which those claims are related). For example, 5% x £450m =£22.5m and this would be the 'target'…"

276. Stripped down, the process as described above was crucially dependent upon the view of Mr Morgan and Mr Josiah as to where Syndicate 218 was in "the underwriting cycle", in other words, in their confidence that conditions at a point of time in the past, which might be well in the past, sufficiently replicated conditions at a later point of time, so that it was safe to perform a file review of similar "intensity", with a view to moving the loss ratio by a similar magnitude; and then to applying that loss ratio to the premium income to produce a "target" monetary sum for the file review. However, as Mr Collier convincingly stated in his evidence, it was imprudent to assume that the relevant conditions at the selected point in a later "underwriting cycle" sufficiently replicated those at an earlier period. Underlying market conditions may well in the meantime have changed in material ways, the loss ratio at the selected later point of time may very well mainly be reflecting underlying altered market conditions; and it would be imprudent indeed to seek to manipulate the targeted loss ratio in the manner implicit in the proposed file review. If the assumption of replication proved false, as could well be the case, as Mr Collier emphasised, the process of the file review would be removing case reserves that, in all probability, would be required to meet outstanding claims. In other words, there was no substitute for a careful and well considered analysis of whether an amount of reserve for an outstanding claim could prudently be reduced in the light of all known and ascertainable information regarding the relevant market conditions and of the likely impact of those conditions on the amounts that the Syndicate would pay to meet claims. The evidence in this case shows that from 2006 the relevant market was undergoing fundamental changes, substantially increasing both the volume and value of claims, and new forms of competition were putting pressure on underwriting margins. Assumptions about equivalence with the past, when market conditions were very different, was both difficult and uncertain.

277. We would go further on this aspect. From the contemporary documents and by his demeanour as a witness, Mr Morgan came across as a person who had almost unshakeable confidence in the validity of his professional opinions, and who did not invite or welcome interrogation of, or challenge, to his definitely formed views. We believe that the lack of transparency concerning the "targets" was deliberate. If the "targets" had been explicitly disclosed to the Board of ESML and to [...] and KPMG, and, especially the underlying, controversial methodology articulated, questions would inevitably have been raised as to the propriety and soundness of the whole approach, and certainly as to the reliability of the specific selections made by Mr Morgan. No witness sought seriously to defend Mr Morgan's unusual and controversial methodology for setting "targets". Mr McConnell, the expert actuary on behalf of Mr Morgan, did not know how Mr Morgan set the "targets", saying that the only relevant question was whether the amounts left in the case reserves, after "targeted" amounts had been removed, by whatever means, remained reasonable estimates of outstanding claims. That seems simply to beg the key question whether case reserves had been adequately established. We also emphasise that there is no contemporary document of any kind describing the methodology that Mr Morgan said that he employed for setting "targets", and there is no contemporary document of any kind setting out the specific calculations that Mr Morgan said that he carried out, as well as explaining and justifying the critical assumptions that he had made and the results that he had managed to achieve.

278. Executive Counsel alleged that the selected monetary "target" for a file review was profit driven. Particularly in his oral evidence, Mr Morgan strenuously denied that that was the case. In passing, it might be noted that his evidence in that regard displayed a very well-informed grasp of the nature, scope and effect of file reviews that sat somewhat uncomfortably with his contention (see below) that case reserving was not really in his bailiwick within Syndicate 218. On the assumption that his description of the process is accurate, it is correct that the immediate purpose of a file review was not favourably to shift the ultimate loss ratio for a relevant accounting period. However, that is part only of the story.

279. There were indisputably pre-determined monetary targets for the relevant file reviews. Those monetary targets were not set by reference to any clear and consistent criteria. On Mr Morgan's own description, the monetary target was calculated to shift the loss ratio at a particular point in the claims development, so that the ratio of incurred claims at the chosen point to premium income for the underwriting year in question appeared more favourable than otherwise would have been the case. If the hypothesis supporting the whole exercise was flawed (see above), the resulting loss ratio at the chosen point could prove seriously misleading to anyone needing to understand the development of the Syndicate's claims experience.

280. Furthermore, the effect of a file review was to remove amounts – sometimes very substantial amounts – from case reserves. To the extent that the syndicate actuary used data from the case reserves to calculate the prudent level of reserves in the accounts for any relevant period, that level was most likely to be lower than would otherwise be the case, producing, ceteris paribus, a reduced ultimate loss ratio and higher profitability for the Syndicate. In our view, Mr Morgan was sufficiently well informed to understand that such would be likely to be the outcome of the process that he was initiating.

281. There was a rather lengthy passage of cross-examination in which Mr Morgan veered between accepting the obvious proposition that the removal of amounts from the case reserves could affect actuarial calculations of reserves and denying that that was the case. At one point he conceded that anything that was in the incurred claims data that flowed into the actuarial modelling would have an impact on the actuarial calculations. He sought to qualify the concession by saying that the actuary could adjust the modelling to take account of, for example, case file reviews. However, Mr Morgan knew that case reserves, as reduced by file reviews, were at least a starting point, and that the reliability of the case reserves, as reduced by file reviews, was likely to be material to the nature of the "adjustment" that was, or might be, required.

282. Furthermore, the whole point of reducing the "funnel of uncertainty" was to encourage [...] to set an amount of reserves that was less conservative than was likely otherwise to have been the case. Mr Morgan in evidence described that circumstance as merely an "outcome" of the case file reviews, and not a "driver". But it was a foreseeable outcome, and it was an outcome that was in fact foreseen by Mr Morgan. There was specific evidence that Mr Morgan could on occasion even calculate, albeit broadly, how and to what extent data on incurred claims was likely to affect [...] actuarial calculations. Mr Morgan clearly prided himself on his mathematical skills and from the evidence as a whole we gained the firm impression that he had a good grasp of [...] work.

283. There was furthermore ample evidence that [...] did rely on incurred claims data in their actuarial calculations. For example, incurred claims data was used to calculate the number of large claims in 2007, and that calculation influenced the assessment of the ultimate loss ratio for 2007 and in turn the reserves for that YOA. At the end of 2008 [...] moved from a paid model to an incurred development model, and so used incurred claims data as the starting point for capped claims as well as large claims. As to the position generally in 2009, see paragraphs 290-292 below.

284. Secondly, the file reviews did not follow any well-designed set of hard- edged rules. For example, it might be understandable, and acceptable, for management of the Syndicate to direct that, shortly before a year of account was "closed", all case reserves, or all case reserves in a particular category of insurance business, for the closing year, and prior years, should be brought to "best estimate". In some instances the possibility was not thereby excluded that, in the light of market conditions and further relevant information, some reserve amounts might need to be <u>increased</u>. The amounts, if any, ultimately removed would vary, but the procedure would follow a consistent, objective standard, even if the assessment of "best estimate" in a particular case depended on exercise of informed judgment. The procedure that was in fact adopted depended upon a vague conception of the "underwriting cycle", an imprecise and questionable correlation of a present with a past point of time; and allowed an extraordinary degree of managerial discretion and control in respect of what was, on all accounts, a crucial element in the determination of the Syndicate's financial performance. Indeed Mr Morgan in his oral evidence stressed the "vagueness" which underlay the process – "no two years were the same" – and put it forward as a positive virtue, no doubt because of the extent of managerial discretion that it afforded. For the reasons stated we do not accept that this feature was benign: rather it was the opposite.

285. Thirdly, the procedure was opaque. It was far from obvious why a particular monetary "target" had been specified, and why particular years of account had been selected. We do understand that, given the practice of "exceptional prudence", some adjustment of the reserves might well be justified. However, the obvious mechanism for such an adjustment – as indeed was accepted by the experts – was through the IBNR. That mechanism was entirely transparent; the appropriate amount would be subject to analysis, debate, and scrutiny by those concerned – the management and Board of ESML, and the Syndicate's actuary and auditors – and would be published in the accounts. We also accept, in the light of the evidence, that a certain degree of "profit smoothing" was regarded as acceptable at the relevant time in the Lloyd's market. In other words, reserves might be fortified at times when underwriting margins were strong ("hard markets"), and amounts of reserves might prudently be released when such margins came under pressure ("soft markets"), in order to promote a more consistent and even level of profitability. However, as again was recognised by the experts, the proper mechanism for any such "smoothing" of profits was the transparent one of adjustment to the IBNR.

286. In his Report, Mr Morgan's own expert accountant, Mr Portsmouth, well expressed this feature:

> *"8.5.4. In using such a process [case file reviews] I would have expected this to have only occurred by explicitly varying the risk margin being applied over and above the best estimates of the claims reserves. This approach would highlight to those less intimately involved in the overall process exactly what was being done so that it could be discussed and challenged by the Board, [...], KPMG and any other stakeholders including [...]."*

287. Fourthly, the setting of specific monetary "targets" was likely to put case handlers under undue and unacceptable pressure to reduce amounts in the case reserves below the amounts that they prudently believed were required to meet outstanding claims. That feature was somewhat dramatically exemplified by the events in 2009. The evidence shows that when case handlers "failed" to reach the specified monetary targets, they were required to review further files until the target was met. It is also clear from the contemporary documents that case handlers were extremely uneasy about this procedure, and the deepening unease was captured in the graphic "squeal" factor, strongly suggesting that case handlers could reach the stipulated target only under severe pressure and with considerable reluctance. Because the process was not properly documented or reported, it remains unclear whether, for example, files that had already been subject to "review" were returned to case handlers for further review. Furthermore, even if case handlers were instructed on review to reduce case reserves to "best estimate", and no lower, the concept of "best estimate" allowed a degree of discretionary judgment, and there was a real risk that case handlers, under pressure to meet the stipulated "target", would reduce case reserves below the level which they would otherwise have regarded as prudent. There was no systematic procedure for retrospective evaluation of the extent to which the results of case file reviews were shown to be justified by the amount of actual payments later made in respect of the claims that had previously been reviewed. The procedure was therefore both undocumented and unregulated.

288. Mr Morgan said in evidence that case handlers were instructed not to make reductions in reserves beyond "best estimate". He also asserted, without any documentary

evidence, that the scenario of "squeals" simply replicated the procedure that had been adopted in the "hard" case file reviews in 2000 and 2001. However, some realism is needed in this context. Case handlers knew that management expectation was that case reserves were to be reduced by a specific monetary amount. That expectation rested upon Mr Morgan's view that such a reduction, in the light of history, was fully justified. As already observed, Mr Morgan emerged, through contemporary material and in his evidence, as a manager who placed a very high degree of confidence in the correctness of his own opinion, and was extremely forceful in seeking to persuade and, where he could, to induce others to accept and follow his views. Particularly in that light the whole procedure of case file reviews, undocumented and unregulated as it was, was susceptible to the grave risk that we have identified, and in 2009 in all probability that risk was realised in the actual conduct of pressurised case handlers.

289. Fifthly, the process, as already observed, was not properly documented. There were no proper written records that specifically recorded the individual case files that had been reviewed, the identity of the individual case handler who had carried out the review, the precise dates of each file review, the amount of the monetary "targets" that had been set, the instructions given to case handlers, the amounts of reserve that had been removed from each of the files, or the amounts re-instated when the file was subsequently examined. There was no contemporary document explaining the rationale for any file review, setting out, in line with Mr Morgan's evidence, where in the "underwriting cycle" the Syndicate was thought to be, what the putative analogue point of time was assumed to be, the amount by which the loss ratio was to be shifted, the target set and the selection of years for review. As noted above, there was no systematic retrospective appraisal of the results of case file reviews, or of the performance of individual case handlers in carrying out such reviews. Reserving was a crucial element in establishing and evaluating the financial performance of the Syndicate, and case reserves were a very significant part of that process. In our view, proper documentation of file reviews was essential, so that all concerned could see what had happened on a review, and why. The risk of manipulation of reserves had been recognised, and that recognition made it all the more imperative to ensure that proper documentation in respect of file reviews was created and retained. It is extraordinary that at the end of 2009 and beginning of 2010 there was such uncertainty about what case file reviews had been carried out, and when – a situation that would have been entirely avoided if proper records had been made and retained.

290. Finally, by 2009 the process of case file reviews had become seriously "degraded". That was the description accurately given by Mr Morgan's own accountant expert, Mr Portsmouth. By then case file reviews routinely occurred twice a year, and the final review at the end of 2009, being one of the bi-annual reviews, was again reducing the case reserves for a number of years which had, in 2008 and earlier in 2009, already been subjected to very substantial file reviews. In 2008 case file reviews had removed over £54 million from the case reserves of the 2005 – 2007 YOAs. 2007 was at that time an "open" year, which according to earlier prudent practice, would not have undergone a file review. It is self evident that the estimate of outstanding liabilities in the early period of development is a very challenging task. Between the end of February and the end of May 2009, a further amount in excess of £48 million was removed from the case reserves of the 2005 – 2007 YOAs, as well as over £13.5 million from the case reserves for the "open" year of 2008. By 2 December 2009, a further £24.5 million of case reserves was removed for the 2005 – 2007 YOAs.

Furthermore, the large reductions in case reserves were being made at a time of considerable concern and uncertainty. Market conditions had deteriorated. It appeared that, for the first time in decades, Syndicate 218 might report a loss. The data in respect of paid claims development looked "ghastly" (Mr Hulse's informed assessment), consistent with serious deterioration of the underwriting account. The data in respect of incurred claim development looked more favourable, but that development rested upon assumptions regarding the reliability of the amounts calculated for outstanding claims, with the apparent misalignment between paid and incurred claims data being materially attributed to "acceleration and leakage", that was by 2009 a questionable hypothesis. In other words, various circumstances were suggesting that, if anything, reserves might need, in the interests of risk aversion, strengthening, a conclusion at odds with the underlying assumption of the case file reviews in this period, namely, that there was very substantial "redundancy" in the case reserves, especially for the 2005 – 2007 YOAs. The purported rationale for the file review at the end of 2009, removing further case reserves from years that had already had substantial "reviews", remains wholly obscure.

291. Mr Portsmouth did candidly accept that in the later period case file reviews had become "inappropriate": that is, case reserves should not have been reduced by the kind of file reviews that the Syndicate was carrying out.

292. In his report Mr Portsmouth stated:

> *"8.4.6. However, the use of a target derived from the expected result from the closing year of account and only reviewing claims until such a target was met is not in my opinion an appropriate methodology, because the overall quantum of the aggregate claims reserves is a prime driver of both the aggregate profitability of Syndicate 218 or of an individual YOA. However, I note that this practice was a longstanding part of the annual file review procedure."*

293. Mr Portsmouth did not, however, agree that Mr Morgan had committed "misconduct". His basic reason for that opinion was that, on his understanding, Mr Morgan did not have "primary" responsibility for case file reviews: "primary" responsibility lay with the lead underwriter, Mr Josiah.

294. We reject that opinion. In reaching it, Mr Portsmouth appeared to believe that the Notices of Censure in the Lloyd's disciplinary proceedings used different language in the respective findings against Mr Josiah and Mr Morgan, which showed that, in the view of Lloyd's, Mr Josiah had "primary" responsibility. Mr Portsmouth was wrong in that belief. The language was precisely the same.

295. Under ESML's "terms of reference", in any event, for Mr Morgan, as finance director, reporting to the chief executive and the Board, was

> *"to assume board level responsibility for the following critical business risk areas…………*
>
> *Reserving"*

296. Mr Morgan contended that "Reserving" in his terms of reference did not include case reserves: they fell within Mr Josiah's terms of reference, where he had joint

responsibility for "claims handling", as well as responsibility, with Mr Morgan, for "reserving" more generally. We do not accept that argument. In our view, "Reserving" included the whole process by which the final amount for "reserves" was established. The term "Reserving" is entirely general. It is not expressly limited to the reserves in the final accounts, and it does not expressly exclude responsibility for case reserves. Furthermore, any implied exclusion would make no sense where a necessary element in the process of determining the final reserves was the setting of case reserves, of which file reviews were an important component. It is implicit in paragraph 8.4.6 of Mr Portsmouth's Report that there was a significant link between the case reserves and the final amount of reserves in the accounts. It may be that under the respective terms of reference Mr Morgan had a <u>joint</u> responsibility with Mr Josiah for "reserving", including case reserves. However, such joint responsibility, or the fact that Mr Josiah was responsible for "claims handling", which is a much narrower concept, did not relegate Mr Morgan, as financial director, to a subsidiary role, and confer "primary" (a term not found in the terms of reference) responsibility in respect to case reserves on Mr Josiah.

297. Furthermore, it is clear from the contemporary documents that Mr Morgan in fact played a prominent role within the Syndicate in respect of file reviews. He took a prominent role, both in relation to the setting of the monetary "targets", and also in generally supervising the carrying out of the file reviews. Mr Josiah was also involved, but from the documents less prominently so; and a fair inference from the contemporary material is that, so far as case file reviews were concerned, Mr Morgan was the leading light. None of this is at all surprising, given the link between case reserves and the final amount for reserves in the accounts, the critical importance (recognised in the terms of reference) of reserving to the Syndicate's financial performance, and Mr Morgan's primary responsibility to the Board for all aspects of financial management.

Applicable standards and misconduct

298. "Misconduct" is defined in the Accountancy Scheme as:

> *"an act or omission or series of acts or omissions, by a Member or Member Firm in the course of his or its professional activities (including as a partner, member, director, consultant, agent or employee in or of any organisation or as an individual) or otherwise, which falls significantly short of the standards reasonably to be expected of a Member or Member Firm or has brought, or is likely to bring, discredit to the Member or the Member Firm or to the accountancy profession."*

299. "Professional activities" are not defined, but in the CIMA code "professional services", which must be a closely related if not equivalent concept, are defined as:

> *"Services requiring accountancy or related skills performed by a professional accountant including accounting, auditing, taxation, management consulting and financial management services"* (emphasis added)

300. Mr Morgan argued that he did not perform any relevant "professional activities". That argument is unsustainable. Mr Morgan was finance director of a substantial Lloyd's enterprise, ESML. In that capacity he exercised, at the minimum, skills that were closely "related" to those exercised by an accountant acting as such; and his professional activities fell squarely within a specific category mentioned in the CIMA code, namely, financial management services. We note also that relevant misconduct may occur entirely outside the scope of "professional activities" or "professional services", by reason of the addition of the words "or otherwise" in the definition. This extension may be recognising that certain conduct might well "bring discredit" to the Member or to the accountancy profession, even if it has occurred entirely outside professional activities (indeed outside commercial activities generally). For example, it might be that the commission of certain criminal offences, even within a non-business context, would fall within the scope of relevant "misconduct", if in all the circumstances the conduct in question was simply incompatible with the integrity and probity required of a member of the accountancy profession. However, in this case it is not necessary to explore the outer limits of the extended definition, for Mr Morgan was carrying on relevant professional activities within the meaning and scope of the accountancy scheme, for the reasons already given.

301. Executive Counsel alleges that Mr Morgan's conduct was in breach of the fundamental principles of the CIMA code, namely, paragraphs 100.4(c) and 100.4(e), as follows:

> *"(c) Professional Competence and Due Care*
>
> *A professional accountant has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A professional accountant should act diligently and in accordance with applicable technical and professional standards when providing professional services.*
>
> *(e) Professional Behaviour*
>
> *A professional accountant should comply with relevant laws and regulations and should avoid any action that discredits the profession."* (emphasis added)

302. Executive Counsel in this context drew specific attention to paragraph 2 of Schedule 2 of the Lloyd's Byelaw and to paragraph 1.6 of the Lloyd's Reserving Risk Code, as follows:

> *"2005 Byelaw Schedule 2, paragraph 2*
>
> *2. Accounting policies shall be applied so as to ensure uniform treatment of like items in respect of each year of account and shall be applied consistently throughout each year of account and from one year of account to the next.*
>
> *Reserve Risk Code*

1.6 …it is essential that there are proper procedures in place to determine that reserves are adequate to meet each syndicate's exposure to insurance risk...

<u>Methodology</u>*. The managing agent needs to be satisfied as to the methodology and data used and assumptions made in relation to the reserve setting process across all its managed syndicates, and is further responsible for ensuring that a consistent high level approach is adopted from one year to the next and between syndicates, except where change can be justified according to circumstances or on the grounds of refinement."*

303. Mr Hubble QC, on behalf of Mr Morgan, submitted that there was simply no legally admissible evidence adduced by Executive Counsel that could properly support a finding by the Tribunal that Mr Morgan committed relevant "misconduct". Executive Counsel relied in this context, it was contended, on the evidence of a single expert witness, Mr Collier. Mr Collier was not an accountant, and he had no direct experience of the Lloyds's market. Mr Hubble QC submitted that on authority "an allegation against a professional person [must] be supported by an expert opinion by a person from the same profession", referring to <u>Pantelli v Corporate City Developments</u> [2011] PNLR 12, and <u>Sansom v Metcalfe Hambleton & Co</u> [1998] PNLR 542.

304. In <u>Sansom</u> the issue was whether a claimant in a civil claim for negligence, who relied exclusively on the expert evidence of a structural engineer, had shown that a surveyor, acting solely in his capacity as such, had exercised reasonable care in producing a survey of a dwelling house. Butler Sloss LJ, with whom Hutchison LJ and Sir John Vinelott agreed, stated the relevant legal principle as follows:

> *"… a court should be slow to find a professionally qualified man guilty of a breach of his duty of skill and care towards a client (or third party), without evidence from those within the same profession as <u>to the standard expected on the facts of the case</u> and the failure of the professionally qualified man to measure up to that standard. It is not an absolute rule … but, less it is an obvious case, in the absence of the relevant expert evidence the claim will not be proved."* (emphasis added).

305. In <u>Pantelli</u> defendant property developers in their proposed defence and counterclaim raised vague and unspecific allegations of poor performance and professional negligence on the part of the claimant quantity surveyors. In striking out those allegations, Coulson J (as he then was) stated:

> *"17 ….. it is standard practice that, where an allegation of professional negligence is to be pleaded, that allegation must be supported (in writing) by a relevant professional with the necessary expertise. That is a matter of common sense: how can it be asserted that act x was something that an ordinary professional would and should not have done, if no professional in the same field had expressed such a view?...."*

306. The context of both <u>Sansom</u> and <u>Pantelli</u> is important. In each case the allegation was that a professional – surveyor or quantity surveyor – <u>acting in his capacity as such</u>, had failed to exercise the care that someone acting in that capacity would have exercised. In the present case Executive Counsel does not allege that Mr Morgan,

acting as an accountant as such, was guilty of misconduct. Executive Counsel alleges that Mr Morgan, exercising professional activities, that are closely linked to professional accountancy activities, as the finance director of a substantial insurance enterprise, failed significantly to perform those activities in a manner that a skilled and competent finance director would have done, in particular, failing to comply with regulatory requirements with which a skilled and competent finance director would have complied. That, in our judgment, is the relevant issue in the present case.

307. On that issue Mr Collier was a relevant expert witness. He had considerable experience in the insurance market. He had worked in claims departments in four UK insurance companies and for several years had been managing director of a very large insurance company, […]. He had detailed and expert knowledge of case reserving and of the manner in which case reserves impact upon actuarial projections and upon the ultimate setting of reserves in the accounts. The principles governing competent and reliable reserving are well understood, and are applicable to all insurance markets. The organisation of Lloyd's is different, probably unique, but the fundamental principles of reserving are the same.

308. In Mr Collier's expert opinion, no skilled or competent finance director of a substantial insurance enterprise would have directed case file reviews of the kind that Mr Morgan directed, with the objectionable features that were revealed by the circumstances of this case. In particular, his conduct violated the fundamental principle of consistency, which is recognised in the Lloyd's Reserving Risk Code (see above). We agree with Mr Collier's assessment. In short, the flawed case file reviews were governed by no hard-edged appropriate rules; they rested upon vague, wholly undocumented criteria; their application depended upon the exercise of a wide managerial discretion that in turn was informed by inappropriate criteria, with the foreseeable result of influencing the amount of reserves in the accounts in one direction only, and of placing undue pressure on those employees who were expected to achieve the selected monetary "target" for each file review.

309. We also note that Mr Portsmouth, who is an accountant and also had considerable experience of the Lloyd's market, agreed that the file reviews were not "appropriate", indeed that in the latter period the process had become "degraded". He was quite candid on this point in his evidence:

> *Q. … it is common ground that there weren't any written rules in relation to the strategic file reviews; no rules about which years of account would be reviewed when; what test would be applied; no written instructions to the reviewers. Mr Morgan says there was deliberate vagueness. In light of your view that it is obvious there should be a consistent and documented process for reviewing case reserves, there was, wasn't there, on any view a very significant and obvious breach of standards?*
>
> *A. There was an obvious breach of the standards…"*

310. Mr Portsmouth continued his answer by re-iterating his view that Mr Morgan was not primarily responsible for that "obvious breach of standards". However, that view was predicated on the (erroneous) belief that Mr Josiah had "primary" responsibility for the case reserves (see above).

311. For completeness we note four further points made in this context on behalf of Mr Morgan. First, it is contended that the Lloyd's Reserving Risk Code (see above) did not apply to Mr Morgan personally, but only to ESML as the managing agent. That is literally correct, but Mr Morgan, as finance director, was responsible for ensuring that ESML complied with the Code, and it was his own personal conduct (together with that of Mr Josiah) which put ESML in breach of the Code. In doing so, Mr Morgan fell significantly short of the standard required of him as the finance director of a substantial insurance enterprise.

312. Secondly, it is contended that the term "reserves" in the Code is restricted to the final figure in the accounts. However, the term is not expressly limited in that way, and in any event there is a close connection between the case reserves and such final figure. A failure of consistency in case reserving carries the real risk of undermining consistency in the final reserves; and conduct that causes inconsistency in case reserving must, to promote the objectives of the Code, fall within the scope of the relevant provisions. On the present argument, a serious and deliberate manipulation of case reserves would not infringe the relevant provision, a result which borders on the absurd.

313. Thirdly, it is pointed out that the Lloyd's Reserving Risk Code is "recommended", rather than strictly mandatory. However, to ensure the objectives of the Code, Lloyds would expect managing agents to observe its principles unless there was some reasonable justification for not doing so. It is accepted that the requirement of consistency is central to the setting of reserves, and it is not suggested that ESML would have had any reasonable justification for declining to follow the relevant provisions in the Code.

314. Fourthly, Mr Morgan contended that he personally did not favour case file reviews, or indeed the entire philosophy of "exceptional prudence", and that he would have been disposed to change the system. However, he believed that any change would have been unduly risky. Mr Morgan accepted that he had not sounded out the Board of ESML on this matter, and there is simply no contemporary document or other independent evidence to support his contention, and, for reasons already explained, we reject it on that ground alone. In any event Mr Collier pointed out that, if the system of case file reviews as operated by Mr Morgan was flawed, as indeed was the case, it would have been both feasible and beneficial to reform the arrangements, and, in discussion with the actuaries, ensure that any new arrangements provided sufficient accuracy and consistency for the purposes of sound actuarial calculations.

315. From an abundance of caution in the present context we would also observe that it is doubtful whether the principle, or practice, illustrated by Pantelli and Sansom can be translated, without more, to a professional disciplinary tribunal such as the present Tribunal. There is deliberately included in the FRC Tribunals a suitably qualified accountant or actuary who has the relevant expertise and experience to evaluate whether impugned conduct has fallen significantly below an applicable standard and to assist other members of the Tribunal in their deliberations on that issue.

316. Finally on this aspect, we need to make clear our judgment that this is not a marginal case. The "obvious breach of standards" fell well below the conduct that could reasonably have been expected of a diligent and competent finance director of a substantial insurance enterprise, and was "significant" in terms of the definition of

relevant "misconduct". No competent and diligent finance director would have acted as Mr Morgan did in relation to case file reviews. At the risk of repetition, we fully recognise that at the time it was understood that Syndicate 218 sought to follow a practice of "exceptional prudence" in case reserving, and that procedures for reviewing case files were not, as such, improper. However, the particular procedures adopted by the Syndicate, of the nature described earlier, were, for the reasons already given, wholly improper.

Allegation (2): Documentation

317. We have already indicated our view that the case file reviews were not the subject of specific and proper documentation (see above).

318. We believe that, in the context of the present proceedings, it is perhaps more appropriate to regard that failure as an aspect, albeit an important aspect, of our conclusion that the file review process, as a whole, of the Syndicate was seriously flawed. It is important, in our view, especially in regard to any potential sanction, to seek to guard against "double counting". However, as a formal matter, we do find that Allegation (2) has been independently established, for the following reasons.

319. First, in regard to documentation, Mr Morgan did face something of an initial formidable obstacle. We have referred to the Lloyd's disciplinary proceedings brought against Mr Morgan. Lloyd's issued a Notice of Censure against him, finding instances of "detrimental conduct". The Notice outlined the background to case file reviews and continued as follows:

> *"4. Unlike other types of reviews, the reserve reviews were based on an instructed level of intensity that varied from review to review and year of account. In 2007-2009 those conducting the reserve reviews were given a target figure.*
>
> *The instructions to carry out these reserve reviews, including the targets to be achieved, came from Mr Morgan (along with another executive director)...*
>
> *Mr Morgan was at all material times the director of Equity responsible for the 2009 year-end process for Equity and the related regulatory filings. The reserve review process was organised, directed and overseen by Mr Morgan with another executive director [Mr Josiah], who together had executive and Board-level responsibility for reserving, including the reserve reviews. Whilst Mr Morgan, as FD [Finance Director] was responsible for overseeing the executive functions of the finance department, he did not have a role in the day to day conduct of the reserve reviews.*
>
> *<u>Mr Morgan accepts</u> that as FD and as the director who organised and directed the reserve review process he had responsibility for ensuring adequate systems and controls were in place in relation to Equity's reserving processes and <u>that he did not take sufficient steps to ensure</u>:*

> 1. *that certain aspects of the reserve process and the results of each reserve review were properly documented by those charged with those tasks and*
>
> 2. *that the Board and the Syndicate's external actuaries were kept properly informed as to the reserve review process and the results of each reserve review."*(emphasis added)

320. Mr Morgan professed in explanation that in effect his mind did not truly move with this admission. He had made the admission, he said, largely out of a sense of "cabinet responsibility", as he called it, for the failings of the Syndicate generally, and to put the whole matter behind him. We did not find that explanation at all credible. From the material that we saw, and from Mr Morgan's demeanour and attitude as a witness, he did not strike us as a manager who would make a very damaging admission in Lloyd's disciplinary proceedings out of loyalty to, and solidarity with, others who had positions of responsibility in the Syndicate, or who would forgo an opportunity to defend his conduct. The case against him was in fact overwhelming, and an admission would provide mitigation and the likely advantage of a lesser penalty. We have already set out the respects in which Syndicate 218 failed to make and retain proper written records of the case file reviews in the relevant period. The making and keeping of such records was an obviously indispensable element of sound and efficient financial management of a substantial insurance enterprise, and was a relatively straightforward task to perform. No good reason has been shown, or could be shown, for the failure. On the contrary, it appears that the absence of proper documentation was a deliberate aspect of the "vagueness" underlying the whole process, a vagueness that Mr Morgan viewed, in our opinion, misguidedly, as a positive virtue of the system that was as such worth maintaining.

321. We again note Mr Portsmouth's view in his report that Mr Morgan's conduct in this respect did not fall significantly short of any relevant standard, because Mr Morgan did not have "primary" responsibility for proper record keeping, but we reject that view for reasons already explained. Mr Portsmouth also said that during the relevant period (2007 to early 2010) the Lloyd's Reserving Risk Code, in so far as it required proper record keeping, was not scrupulously followed. However, the Code had by then been in force for almost 10 years and managing agents had had ample opportunity to align their practices with the provisions of the Code. In the proceedings against Mr Morgan there is no reference to any lax market practice in this respect, or any suggestion that it would constitute a significant mitigating factor. In addition, there was no real practical difficulty in this case in ensuring that full and proper documentation regarding case file reviews was created and retained. Indeed in 2004 [...] had published a report which criticised the Syndicate's failure to keep a record of annual rolling reviews. In our view, it was all the more important to keep full and proper records of the kind of systematic and extensive case file reviews between 2007 and 2010 that have featured in these proceedings.

322. Finally, we note Mr Morgan's point that the email of Mr [...] of 2 December 2009 shows that the claims department kept some written record of case file reviews. However, there is no evidence of any systematic record keeping by the claims department, and a bare list of years of account and amounts of case reserves removed at each file review would fall far short of the detailed record keeping and written documentation that we have already described.

323. We have no doubt that the failure in regard to documentation was significant, and constituted relevant "misconduct".

Allegation (3): failure to communicate

324. Executive Counsel specifically relied upon Rule 12 and Appendix 3 of the Lloyd's 2009 Valuation of Liabilities Rules (as regards the 2009 financial year) and paragraph 3.2 of the Lloyd's Reserving Risk Code.

325. It is again apparent that in the Lloyd's disciplinary proceedings Mr Morgan admitted his failure to communicate with relevant parties, as was amplified in the Notice of Censure:

> *"Lloyd's Valuation of Liabilities Rules require managing agents to provide its syndicate actuary with appropriate assurance as to the accuracy and completeness of the data provided for the purpose of obtaining a "Statement of Actuarial Opinion" ("SAO") in respect of the year-end reserving position of each syndicate under its management. This is achieved through the provision of a "Data Accuracy Statement".*
>
> *The Syndicate's external actuaries produced two reports at the end of 2009, one entitled "Valuation as at 31 December 2009" dated 24 February 2010 and the other, being the 2009 Year End Report, dated 14 April 2010.*
>
> *Mr Morgan was the director responsible for the year-end process and was the signatory of the relevant Data Accuracy Statement. He had responsibility for ensuring that accurate and complete information was provided to the Board and the Syndicate's external actuaries.*
>
> *Due in part to the governance issues over the reserve review process set out above in respect of Charge 1, Mr Morgan was not able to satisfy himself that accurate and complete information regarding the reserve review process was provided to the external actuary.*
>
> *Mr Morgan accepts that he did not read either of the reports identified above and consequently was not in a position to correct any errors that they may have contained.*
>
> *Mr Morgan had therefore admitted one charge of detrimental conduct (pursuant to 3(b) of the Enforcement Byelaw) in respect of the above."*

326. Notwithstanding the admission made in the Lloyd's proceedings, Mr Morgan contended that there was no significant failure in this respect that could amount to misconduct. There was a common theme in this contention.

327. As to communication with the Board of ESML, we accept that some of the minutes and papers put before the various ESML committees referred in general terms to case file reviews. For example, the minutes of ESML's Audit Committee on 29 July 2009

referred to a 5 per cent saving that had been factored into [...] methodology to cover residual redundancy in claims as a result of a current incomplete file review, and also recorded an observation by Mr Rakow that it was crucial that the file review be completed in order to get to the "best estimate" position […]. Mr [...], who became a director of ESML towards the end of 2009, also confirmed in his evidence a broad understanding of case file reviews.

328. However we are satisfied on the evidence that the Board was not at any time alerted to the important, and objectionable, features of the file review process that we have already adumbrated, in particular, the setting of monetary "targets" for each review, and the precise methodology employed for the setting of those "targets"; nor were they informed about the pressures brought upon case workers to ensure that the "targets", set as they were, were met. [...].

329. Mr McConnell, the expert actuary on behalf of Mr Morgan, said that because the Board relied on [...] to guide their view of reserves, he would not expect the Board to need specific details of the file reviews. However, for the reasons already stated, we prefer the evidence of Mr Collier that it was important for the Board to understand how the case file reviews were conducted, particularly the methodology used by Mr Morgan to determine the "targets", the procedures adopted to ensure that case handlers met the "target" set and, in respect of 2009 particularly, the amounts of case reserves that were systematically removed pursuant to the stipulated "targets".

330. On this issue generally Mr Collier was an impressive witness, and part of his oral evidence merits quotation:

> *As I have observed and in my experience the insurance business passes the actuary the data and also gives the story behind the data and that is important in terms of context. The actuary then applies actuarial technique and applies judgment, so those are the four component parts as I see it.*
>
> *… Those claims are reviewed consistently and significantly. The data and the story emerges from that and is given to the actuary. There is a debate with the actuary about the story and the background to the data. The actuary will then create their report on their best estimate of the central reserve for outstanding liabilities for the business. It is then for the board to decide what level of reserves to put in the accounts….*
>
> *Q. In the light of that role and in light of Mr Morgan's setting of targets for the file review process, what information do you consider that Mr Morgan needed to provide to the Board for them to fulfil their role?*
>
> *A. Complete transparency of the review process that he was effectively managing. So these are the reviews that we have done in these periods, this is the process by which the review is followed. I have set targets to remove certain levels of redundancy. This is done at a point just before we close our financial year and it is done in relation to a view on the level of a profitability that I will affect by reducing, removing, a certain level of case reserves from there.*

So the board needs to know there is not a consistent process in place. They need to know there is influence by individual board members of the outcome on the process of claims case reserve reviews.

Q. What if any information should have been supplied to the board in relation to the sums removed?

A. All of it….

331. As to [...], we accept that [...] knew the timing of the file reviews and that they varied in "intensity". This is evident from a number of contemporary documents. For example, [...] knew that in 2009 ESML intended to carry out an intense case file review of the 2000 – 2004 YOAs, bringing the case estimates to a "best estimate". In particular, [...] reports of 24 February 2010 and 14 April 2010 noted that during the first half of 2009 ESML had carried out a file review of "redundancy" in claims reserves for the 2000 – 2003 underwriting years of account, and that the results of that procedure were reflected in [...] calculations as at 30 June 2009, remarking that ESML had *"carried out such a file review before in 2000 and 2001, specifically for the 1998 and 1999 years of account"*.

332. We also accept that, to some extent, the incidence and effect of case file reviews might be apparent from data that was provided to [...]. In his interview with [...] on 20 October 2010 Mr Rakow observed that when a file review had taken place, incurred claims would fall sharply, then increase, creating a "saw tooth" aspect on scaled graphs which showed the cumulative incurred claims as a percentage of expected total claims at appropriate points for the relevant periods, on the basis of assumed ultimate loss ratios for the underwriting years in question. In re-examination, Mr Morgan was asked about a "triangle" of data produced by ESML. He explained that the data showed a reduction in case reserves for the 2009 and 2006 YOAs, occurring between February and May 2009. These reductions in the case reserves corresponded with the figures in Mr [...]'s email of 2 December 2009. Any knowledgeable person examining the data might infer that there had been a case file review between February and May 2009 (as was the case) of the 2006 and 2007 YOAs. We do, however, note that the same exercise for the underwriting years 2005 and 2008 (an open year) would not, without more, disclose any case file reviews between February and May 2009. For the 2005 underwriting year case reserves were £175.8 million in February 2009, and increased to £233.2 million in May 2009, notwithstanding that a file review during that period had reduced the case reserves by £14 million. For 2008, case reserves were £212.7 million in February 2009 and increased to £270.7 million in May 2009, notwithstanding that a case file review during that period had removed £13.5 million of case reserves. In his witness statement for the Lloyd's proceedings Mr Rakow said that in the "triangles" that he had seen for the period ending 30 November 2009 he had not observed the movement which he would have expected if the 2005 and 2006 YOAs had been subject to file reviews. Between February and May 2009 £31 million had in fact been removed from the case reserves for those years; and between 14 November 2009 and 2 December 2009 (shortly after the cut off date of 30 November) a further £7.5 million had been removed.

333. It seems to us that the re-construction of case file reviews from data such as the "triangles" was a somewhat uncertain exercise. In early 2010 when the issue of what file reviews had been conducted in respect of the 2005 and 2006 YOAs arose, it was

not suggested that a confident answer could be reached by poring over the "triangles", and as noted above such recourse could well positively mislead. Even as late as May 2010 [...], ESML's in-house actuary, was still seeking to establish the true position regarding case file reviews for the 2005 and 2006 YOAs, and plaintively admitted defeat. Later on Dr […] , the expert actuary who arrived on the scene to conduct a full investigation of the reserving position, was uncertain as to what case file reviews had been conducted despite the available data on incurred claims and case reserves. For certain periods a broad estimate might be obtained by an informed person who knew what he or she was looking for, but there were likely to be periods in which the incidence and extent of case file reviews might not be apparent. There was typically a considerable volume of "noise" around the data, in terms, for example, of increases in incurred claims as underwriting years matured, of ordinary ongoing claims activity with the payment of claims, and of upward re-adjustment of case reserves where case workers had reason to re-visit the file. Mr McConnell, the actuary expert on behalf of Mr Morgan, produced examples illustrating how a skilled actuary could infer the incidence of, and broad amount removed by, file reviews, but he did make clear that, if he had been the Syndicate's actuary, he would have required the Syndicate to produce comprehensive and accurate information, broken down by amount and class of business. Mr Morgan also said that the scaled graphs indicated the extent of "redundancy" in the case reserves at various points of time. However, the putative "redundancy" in the graphs depended critically on the loss ratio assumed for the underwriting year in question; and the loss ratio came to depend on a projection of incurred claims, the estimate of which came back to the soundness of the case reserves. Claiming that the graphs showed "redundancy" involved significant circularity of reasoning. If for any reason the actuarial calculations were flawed, the assumed "redundancy" was a phantom.

334. We do not believe that this question is in any event central to the allegation. In our view, the most significant omission in the communications with [...] was the failure of Mr Morgan to explain fully and frankly to [...] that, for the purposes of case file reviews, he fixed a specific monetary "target"; that he decided on the appropriate "target" by reference to the underwriting cycle and an assumed replication of past claims experience; and that he expected case workers to remove the stipulated "target" amounts from the case reserves, reviewing further files, if need be, to ensure the desired objective, with the accompaniment of an indicative "squeal" factor, which monitored the extent of resistance on the part of case workers to the task assigned to them.

335. It is no answer to say that [...] could, and should, have sought more information about the case file reviews. We refer again to the evidence of Mr Collier that a finance director of a substantial insurance enterprise must tell "the full story" to the actuary, and is not entitled to hold back, assuming that the actuary, if he does not pursue a line of enquiry, has all the information that he needs. In this case the "full story" required disclosure of the particular features of the case file reviews that we have identified. Mr Morgan's failure in this respect was serious and fell significantly below the standard required of him as a diligent and competent finance director of a substantial insurance enterprise.

336. Executive Counsel submitted that Mr Morgan's general failure in communicating with [...] was exacerbated by his failure to recognise a clear error in [...] reports at the

end of 2009, namely, the "[...] Valuation as at 31 December 2009" dated 24 February 2010, and the Lloyd's "Review of Technical Provisions as at 31 December 2009" dated 14 April 2010. As already noted, in the Lloyd's disciplinary proceedings, Mr Morgan accepted that he did not read either of those reports and was not in a position to correct any errors that they may have contained.

337. There was an earlier draft of the 24 February 2010 [...] Report, referred to above, dated 16 February 2010. Mr Morgan stated in his oral evidence that he read the draft report. In the Lloyd's proceedings Mr Morgan did not refer to his reading any draft report. If he had read a draft, he might have been expected to tell Lloyd's that he had done so, in order to show that he was at least aware at the time of the matters set out in the report, especially the part dealing with case file reviews in the fourth quarter of 2009. We have very grave suspicions that in the Lloyd's proceedings he was unwilling to admit that he had knowledge at the time of what the report contained regarding file reviews, lest he be pressed on his failure to correct what appeared to be a material error in the report. However, we cannot be certain that that was the case, and we proceed on the basis that Mr Morgan did read a draft of the final report, as he had told this Tribunal. We also proceed on the basis that the final report could reasonably have been expected to be in the same, or very similar, terms as the draft. These circumstances (not before Lloyd's in the disciplinary proceedings, as explained above) do mitigate to some extent his failure in this respect. However, in our view, the mitigation is substantially weakened by the fact that both the draft and final reports contained what, on one interpretation, was a seriously inaccurate statement, or on another interpretation, was at least a misleading statement on an important matter.

338. In Section 7.3.1.2 the draft [...] Report stated:

> *"As at 30 November 2009 Equity informed us that this claim review process had not been undertaken for the 2005 and 2006 underwriting years";*

339. and in Section 7.3.1.3 the draft [...] Report repeated:

> *"As mentioned in Section 7.3.1.2. a claim file review was not undertaken in the fourth quarter of 2009 for the 2005 underwriting year."*

340. It is known that a case file review in respect of the 2005 and 2006 YOAs had begun on 14 November 2009. Between 14 November 2009 and 2 December 2009 £7.5 million had been removed from the case reserves for those years by file reviews. On one possible interpretation, the draft report might have been strictly accurate, because the file review beginning on 14 November 2009 might not have been fully completed by 30 November 2009. Because no proper records were created and maintained it is not possible to determine the exact date when the file review was completed, or the amounts of case reserves that were removed at the completion of the file review. However, in our view, looking at the matter more roundly, it is evident that [...], and anyone reading these reports (especially given the April 2010 date of the Final Report), would be very likely to be labouring under an understandable and serious misapprehension, namely, that no file review at all had been carried out in the final quarter of 2009 in respect of the 2005 and 2006 YOAs. This raises the question as to what Mr Morgan knew about the file review beginning on 14 November 2009.

341. On 1 December 2009 [...], ESML's in-house actuary, emailed [...], ESML's head of claims, saying that, on looking at the data for the 2004, 2005 and 2006 underwriting

years, she was unable to observe a decrease in the incurred claims. (This also of course shows the difficulty, even for an experienced actuary, in discerning case file reviews from raw data, such as graphs and "triangles"). She was aware that some case file reviews had recently taken place, and was no doubt thinking that these years might well have been subject to file review, which might in some cases be apparent from the data to which she referred. She therefore asked Mr [...] whether the 2005 and 2006 YOAs had in fact been subject to recent file reviews. Her email was copied to Mr Morgan. Later on 2 December 2009 Mr [...] replied by email, saying unequivocally, but incorrectly, that *"no work [viz. by way of case file review] has been undertaken on [20]05 or [20]06 [YOAs]"*. That email was also copied to Mr Morgan. In his witness statement for these proceedings Mr Morgan said without any qualification that he had not been aware of these two emails. That plainly was not correct, because later on 2 December 2009 he responded to Mr [...]'s email, under the chain heading, "November Claims Review". In his oral evidence, when tackled on this matter, he did change his position from that in his witness statement, and accepted that he had received and read the two relevant emails.

342. Finally on 2 December 2009 Mr [...] sent his email to Mr [...], under the subject "Strategic Review", stating the true position regarding the case file review of 2005, 2006 and 2007 YOAs, including the amount of case reserves removed between 14 November 2009 and the date of the email. At 6.52am the next day, 3 December 2009, Mr [...] forwarded Mr [...]'s email to [...]. No copy of these emails was sent to Mr Morgan, who said that he had no knowledge of them at the time. That in itself would be somewhat extraordinary, given that Mr [...], head of claims, was by close of business on 2 December 2009 in possession, within hours, of important information that directly contradicted what he had just told Mr Morgan, his finance director, about the position regarding the 2005 and 2006 YOAs.

343. In his oral evidence Mr Morgan said at one point that he had no reason to doubt what Mr [...] had initially told [...] about recent case file reviews, namely, that "no work" had been carried out on the 2005 and 2006 YOAs. We find that evidence entirely unconvincing. Mr Morgan knew that case file reviews generally took place before the end of November, so that the results could be taken into account in [...] year- end calculations. He would have had no reason to believe that the 2005 and 2006 YOAs would not have been subject to any such file review. Indeed, at another point in his evidence, when pressed on this aspect, he said that he found the information from Mr [...] to be "curious", and suggested that he did challenge Mr [...] on its accuracy at a meeting (presumably before Mr [...] received Mr [...]'s email which correctly set out the position). In any event it is very difficult to believe that by 16 February 2010 (the date of the relevant [...] draft report), over 2 months after receipt of Mr [...]'s erroneous email, Mr Morgan did not know the true position, namely, that the relevant case file review of the 2005 and 2006 YOAs had begun on 14 November 2009, before the critical date of 30 November 2009. It is all the more difficult to believe that to be the case, when on 2 December 2009 Mr [...], the bearer of the "curious" and in fact false information, had been told the true position by Mr [...]. In any event when he read the draft [...] report of 16 February 2010, it was a simple matter for him to corroborate its accuracy with Mr [...], who had been the source of the information that Mr Morgan had at the time found, understandably, to be "curious". That was the course that a careful and competent finance director would have followed in these circumstances. No doubt Mr [...], with the benefit of Mr [...]'s email, would have

explained the correct position to Mr Morgan. However, Mr Morgan did nothing, and so failed to ensure that [...] were not proceeding on false information, or at the very least that [...] had a complete understanding of the final quarter case file review in respect of the 2005 and 2006 YOAs.

344. Mr Morgan contended that other documents show that [...] knew that the 2005 and 2006 YOAs had been subject to case file review. We have considered the documents referred to, but we are not persuaded that they clearly show that to be the case, and in any event the reports cited above demonstrate conclusively that [...] in its actuarial calculations proceeded on the basis that no case file review of the 2005 and 2006 YOAs had taken place in the last quarter of 2009 before 30 November 2009. Mr Morgan, supported by Mr McConnell, also contended that any failure to correct misapprehension on [...] part did not matter, because [...] was able to "work round" the (assumed) fact that no file review had taken place, by hypothesising for itself, in precise terms, the amount of case reserves that would have been removed if such a file review had taken place. We do not accept that that is a satisfactory answer. It was important that [...] should proceed on an accurate basis, and not be unnecessarily compelled to work on hypotheticals as a result of any misapprehension that could, if competent and careful steps had been taken, easily have been dispelled. Furthermore, it is not clear to us, on the documents that we have seen, that [...] understood that <u>any</u> substantial case file reviews of the 2005 and 2006 YOAs had taken place at any time in 2008 and 2009. Almost £50 million of case reserves for those years had been removed in 2008, and a further £31 million had been removed between February 2009 and May 2009. Nonetheless in its hypothetical calculation [...] proceeded on the basis, for reasons that are not articulated, that there remained as at 30 November 2009 substantial "redundancy" in the case reserves for those years.

345. In summary, even on the most generous interpretation of these events, Mr Morgan failed to take the steps that a careful and competent finance director would have taken to ensure that [...] had a full understanding of what case file review of the 2005 and 2006 YOAs had in fact been undertaken in the fourth quarter of 2009, and to eliminate the risk that [...] was proceeding on an incorrect basis or on an incomplete and misleading understanding of the true position. In our view, the matter was important and the necessary steps were elementary. The failure represented a significant breach of relevant standards of care and competence required of a finance director, and, as charged by Executive Counsel, exacerbate Mr Morgan's more general failure under the present heading.

346. Furthermore, both Mr Collier and Mr Portsmouth stated that Mr Morgan should at the very least have read the final [...] report of 14 April 2010, and should have corrected any error or misapprehension in that report. Mr Morgan accepted that he did not read the Final Report. He said that at the time he was "stranded" in the United States owing to weather conditions and was unable to download the report on his Blackberry device. Given the importance of the report and his position in ESML, we do not accept that, if Mr Morgan had been duly diligent, he would not have been able to find means to obtain and read this important final report. Mr Morgan also contended that he was no longer finance director at the time, having become commercial director and having been replaced by Mr [...]as finance director. In his witness statement and in his oral evidence Mr [...]was adamant that he became finance director only on 12 May 2010. That is confirmed by the Syndicate Report and Accounts 2010, which recorded

unambiguously that Mr [...], [...] Chief Financial Officer, "assumed the responsibilities of ESML Finance Director in May 2010". ESML Board minutes for 12 May 2010, dealing with "job descriptions", imply that Mr [...]became Finance Director on 9 April 2010, but the minutes are inconsistent with the clear statement in the Syndicate Report and Accounts 2010 and with Mr [...]'s own firm evidence. Mr [...]explained that his line manager, Mr Utley, told him on several occasions that he would become effective finance director only when the 2009 year was finally closed and all ancillary tasks, including the finalisation of [...] actuarial report, were completed. We do not doubt that that was the true position, nor do we doubt that Mr Morgan was aware of the situation. On any view, Mr Morgan was finance director throughout 2009, he remained a director of ESML, and the final report of 14 April 2010 dealt with important matters, including reserving, for which Mr Morgan had been responsible at the relevant time. Mr Morgan knew that, by virtue of his role and responsibilities, he was expected and obliged to give close attention to the final report of 14 April 2010, and to take appropriate steps to correct any error or misapprehension in that report. On his own admission, he failed to do so, without reasonable excuse, and fell in that respect significantly short of the standard of diligence and competence required of him. We find that that failure again exacerbated the more general failure, set out above, in respect of communications with [...].

347. As to communications with KPMG, it is clear from the evidence that Mr Morgan did not inform KPMG, as auditors, about the exact nature of the case file reviews, having the features that we have identified. Both Mr Taylor and Mr Hulse believed that, essentially, case reserves were, following the [...] acquisition, reviewed twice a year, the closing year and prior years being the subject of review. Even as late as 24 July 2009 [...], a senior KPMG actuary, was displaying a rather patchy understanding of the process and seeking somewhat basic information.

348. It is insufficient for Mr Morgan to point to evidence that shows that KPMG knew that case file reviews were taking place, and that amounts of reserves were being removed as a result of that process. KPMG did not know that Mr Morgan set specific monetary "targets" for case handlers, did not know how such "targets" had been set with reference to the underwriting cycle, and did not know the steps that were being taken with a view to ensuring that case handlers removed from the case reserves the amounts that the "targets" stipulated. It is no answer to say that KPMG could, and should, have made further and better enquiry about the nature of file reviews and of the procedures followed in carrying them out. As Mr Collier stated, it was the obligation of Mr Morgan, as a diligent and competent finance director, to provide to ESML's auditors a full and frank exposition of both the special features of the case file reviews and of the procedures that were followed. Again we do not doubt that, if Mr Morgan had provided such a full and frank exposition, KPMG, if they acted competently and diligently as auditors, would have initiated discussions with all concerned, including the Board of ESML and [...], as to whether file reviews should properly be conducted, particularly in the conditions in 2008 and 2009, in the manner that Mr Morgan (with Mr Josiah) were conducting them. We conclude that Mr Morgan's failure in this respect again fell significantly short of the standard required of him as finance director of a substantial insurance enterprise.

349. Executive Counsel goes further in this matter and contends that Mr Morgan positively misled KPMG as to the nature of case file reviews. On 2 March 2010 Mr Morgan

made an oral representation to Mr Hulse, and on 18 March 2010 Mr Morgan, on behalf of the Board of ESML, made the same representation in writing, namely:

> *"14. The board confirms that the methodology employed by the Syndicate and its outsourced claims handlers … in relation to the setting of case reserves both for bodily injury and larger accidental damage claims have remained consistent throughout the period from 2002. The board also confirms that the changes made to claims processes in recent periods have not impacted the case reserving philosophy or basis employed by claims handlers."*

350. All the witnesses, except Mr Morgan, agreed that the relevant representation related to the whole process of setting reserves, including the procedures for establishing case reserves which in turn involved case file reviews. That, in our view, is the natural meaning of the words of the representation and is also consistent with a context in which the data derived from case reserves potentially affected actuarial calculations. Mr Collier stated, and we accept, that, in terms of proper reserving practice, a methodology that embraced file reviews having the characteristics already described could not be regarded as "consistent" and the representation was therefore incorrect.

351. Mr Hulse also confirmed his view that the criteria for file reviews adopted by the Syndicate meant that the case reserving was not "consistent", and that accordingly he and KPMG were being misled. We agree, and we note that no witness, other than Mr Morgan, was prepared firmly to say that the file review process within Syndicate 218 conformed with proper reserving practice, or that, in terms of such practice, the methodology for reserving could fairly be described as "consistent".

352. Mr Morgan sought to defend the representation on the basis that he and Mr Josiah had always approached file reviews in the same way, along the lines described earlier in this decision, and that there was therefore a "consistency" in what they did. It may well be that at the time Mr Morgan, on that putative basis, honestly believed that the representation was correct, and in any event it is not alleged in the Formal Complaint that he made the representation knowing that it was false. However, the fundamental difficulty with the defence put forward is that neither Mr Hulse nor anyone in KPMG knew the full nature of the file review process at the Syndicate, and Mr Morgan knew that that was the case. Without further explanation, therefore, the representation was seriously misleading. Faced with the need to make such a representation, a competent, diligent and scrupulous finance director in the position of Mr Morgan would have explained to the Syndicate auditors in detail the full nature and scope of the file reviews that had taken place, so that Mr Hulse and others in KPMG would have completely understood what Mr Morgan meant by "consistent methodology" in the relevant context. Of course, the consequences of such complete and candid revelation in March 2010 might well have been unwelcome to Mr Morgan.

353. In this respect also we find that Mr Morgan fell far short of what was required of him, and committed "misconduct".

354. Finally, on this topic, Mr Morgan signed the standard form "Data Accuracy Statement" for each year. In particular he signed the Statement in respect of 2009 on 24 February 2010. In our view, he was in no proper position to sign the Statement, to the effect that the data and information provided by the Syndicate to [...], as Syndicate actuary, was "accurate and complete". The data was not "complete" because of Mr

Morgan's failure to inform [...] of the full nature and scope of the file review process. Furthermore, for the reasons already explained at length, Mr Morgan, on the most generous interpretation of events, should have known that the data provided to [...] in respect of case file reviews for the 2005 and 2006 YOAs was either incorrect or incomplete.

355. The Data Accuracy Statement was an important part of the process by which [...] issued an unqualified SAO for 2009. In our view, Mr Morgan's conduct in this respect simply reinforces the conclusion that Allegation (3) is well founded.

Allegation (4): Persistence with claim file reviews in a period where the underwriting account was plainly deteriorating, and increasing the frequency of case file reviews in a period of deterioration of the account where it was especially necessary to ensure that case reserves were adequate to meet the level of claims.

356. We have already stated that an exacerbating feature of the file review process was that in 2009 and the beginning of 2010 there was widespread concern about the performance of the Syndicate. It was known that a number of changes in the relevant market had the very real potential of significantly weakening the profitability of the Syndicate. It was, admittedly, difficult to gauge the incidence and effect of such changes on the Syndicate's performance, but, on any view, there was a real and substantial risk that the account had materially deteriorated. As the Syndicate moved through 2009, there was a widespread, growing anxiety concerning the true picture, and a general palpable apprehension that, for the first time in decades, the Syndicate might well have to close the 2007 YOA at a loss, the extent of which was still in doubt.

357. This anxiety and apprehension is powerfully evidenced in the contemporary documents. One factor stood out and could not be denied: the amount of paid claims had risen alarmingly (Hulse: "ghastly"); paid claim development, however, was no longer being treated as a reliable actuarial yardstick. This factor focused attention on incurred claim development, and on the appropriate amount of reserves to meet outstanding claims liability. It is clear that [...] was most concerned to obtain exact information about case file reviews, others at a very senior level were questioning the reliability of case reserves, with KPMG even requesting and obtaining a specific representation on this matter. A relative "outsider", Mr [...] in [...], with rather limited experience of the Syndicate, appears quickly to have put his finger on some very troublesome vulnerabilities. At the 59th minute of the eleventh hour Mr Rakow produced a Note that again would ring warning bells: his quite recent calculation of "redundancy" in the case reserves was on more mature reflection likely to be overstated and needed significant downward adjustment. In the event he stated at the time that the actuarial calculations depended crucially on an assumption that was, on one view, false and certainly susceptible to better informed evaluation.

358. It is for these reasons that we concluded that Mr Morgan's failure was especially egregious. However, in Allegation (4) Executive Counsel seeks to go considerably further. In essence Executive Counsel seeks to present a picture in which Mr Morgan knew, or did not care, or was grossly careless, that the Syndicate's performance was significantly deteriorating, and that he then offered explanations that he knew were false or at least which he had no good reason to believe, with a view to ensuring that 2009 Syndicate 218 showed a profit. In other words he became an advocate for the Syndicate, vis-à-vis [...] and KPMG, exercising "spin" to present as rosy a picture as possible and downplaying what appeared to be worrying aspects.

359. It is possible to select from contemporary documents material that would support Executive Counsel's extended case. However, we do not believe that it would be fair to do so. First, Mr Morgan, as Finance Director, could reasonably be expected to be urging on [...] and KPMG a favourable interpretation of material factors, so long as he had some basis for his contentions. [...] and KPMG could reasonably be expected to be highly skilled and experienced, and sceptical, professionals, so that they could be expected to challenge Mr Morgan's assertions, especially if these assertions bore upon the accurate reporting of the Syndicate's results.

360. Furthermore, we had no oral evidence from [...]. Mr Rakow had been dealt with and might have been thought well placed to assist in the matters raised by Allegation (4), on its extended basis. No one else was called as a witness apart from Mr [...], who came on the scene at ESML quite late. There was no direct evidence in these proceedings from ESML, either from a Board member at the time or any other officer or employee who was likely to have had knowledge at the time of the matters raised by Allegation (4).

361. Given also the passage of time that has elapsed from the events in question, we are not satisfied that we can fairly find Mr Morgan guilty of Allegation (4), in so far as it seeks to incriminate Mr Morgan more deeply than we have already determined in respect of the earlier Allegations.

E. THE KPMG RESPONDENTS

362. The allegations against the KPMG Respondents are reproduced at Annex B to this decision.

363. In closing Executive Counsel submitted that the question that really matters in relation to KPMG and Mr Taylor is:

> *"Whether there was sufficient appropriate audit evidence for them to conclude to a level of reasonable assurance that the financial statements for the years ended [31 December 2008] and [31 December 2009] gave a true and fair view of the Syndicate's financial position."*

364. Allegations 11 and 19 capture that core question, and it is helpful to set out Allegation 11 (in respect of the year ending 31 December 2008):

> *"<u>Failure to obtain sufficient audit evidence</u>*
>
> *In respect of the 2008 Year, the conduct of KPMG and Mr Taylor fell significantly short of the standards reasonably to be expected of a Member Firm and Member respectively in that they failed to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion, as required by paragraph 2 of ISA 500, thereby failing to act in accordance with the Fundamental Principle of Professional Competence and Due Care of the ICAEW Code."*

365. Executive Counsel maintains that Allegations 5-9 (in respect of 2008) and Allegations 13-17 (in respect of 2009) are "stepping stones" to justify the core conclusions, explaining "why and how these audits [for 2008 and 2009] went wrong". Allegations 10 and 12 (for 2008) and Allegations 18 and 20 are "conclusory" points that follow only if the core allegations are established.

366. There was no real dispute between the parties that KPMG's central task was to assess the risk of material misstatement and to obtain sufficient appropriate audit evidence in relation to each such risk to enable them to express an audit opinion. Nor was it seriously disputed that, in calculating the provision for outstanding claims, [...], as Syndicate Actuary, had to use relevant data supplied by ESML, had to make important assumptions regarding matters influencing the development pattern emerging from the data, and had to design and apply appropriate actuarial methodology.

367. The nub of Executive Counsel's case was that KPMG's audit work, discernible already by the failure properly to plan the audits, went no further than the generality that the reserves gave rise to the greatest risk of misstatement; and an alleged unthinking assumption that this could be met by reconciling the data relied upon by [...] to the Syndicate's RTM system and relying upon [...] estimate of the reserves and the KPMG's actuaries' review of that estimate.

368. Executive Counsel contended that, fundamentally, there was no (or no adequate) appreciation by the core audit team at KPMG that [...] calculations as at 31 December 2008 and 2009 themselves depended upon the reliability of the incurred claims data and the factual assumptions made by [...] about claims process changes and their effects; and that neither [...] nor the KPMG Actuaries had audited the data or the assumptions. It was, in the words of Mr Hulse, *"in the end ... a <u>reliance audit</u> on the work of [...]"* (our emphasis). Executive Counsel contended that KPMG's misperception of the full nature and extent of its task was reflected in the repetitive, and inadequate, planning process, and in the "very poor cut-and-paste audit documentation" (a justified criticism in our judgment); and that KPMG was unduly influenced by its wish to foster the relationship with [...], leading it to support the [...] half-year figures as at 31 December 2008, even though it had not received an actuarial report from [...] or any review by the KPMG Actuaries.

369. As to Mr Hulse, Executive Counsel's case in essence was that Mr Hulse decided on 2 March 2010 that KPMG could properly sign an unqualified audit opinion, which no reasonable auditor should have done; but for that decision KPMG would not have

signed the audit opinion; and, accordingly that Mr Hulse committed relevant "misconduct". We explore that aspect in greater detail in the closing part of this decision.

2008 Audit

370. It appears to us that Executive Counsel's central criticism of the 2008 Audit (and also of the 2009 Audit) was the failure of KPMG to address the matter of case file reviews in Syndicate 218. We have already explained at length, in deciding Mr Morgan's case, the nature of the case file reviews which in fact occurred during the relevant period, and the objectionable features of the process. KPMG knew that Syndicate 218 claimed that it followed a policy of "exceptional prudence"; that case file reviews occurred at various times of the year; and that they were of varying intensity. KPMG also knew that file reviews reduced the amounts of case reserves in the Syndicate, and that the amount of case reserves could form a significant part of the actuarial calculation of the reserves in the final accounts. In oral evidence, Mr Hulse and Mr Taylor acknowledged that position.

371. [...] changed its actuarial methodology several times, as KPMG were aware, and in particular in 2008 [...] moved to a model of incurred claim development, by which the amounts of case reserves assumed heightened importance, a matter also known by KPMG.

372. However, it does not appear from the contemporary documents, or from the evidence generally, that KPMG sought to gain any real understanding of the process that the Syndicate employed in carrying out file reviews. It does not appear that KPMG sought to ascertain what specific criteria the Syndicate used to determine the precise "intensity" of a file review; whether any such criteria were recorded anywhere in writing; whether the Board had approved any such criteria, and, if so, when; what procedures, if any, were in place to review the criteria; the dates when case file reviews took place; the details of each review, including particulars of the files reviewed and amounts removed, including the extent to which less mature, "open" years were subject to file reviews; and what tests, if any, were carried out to evaluate the correspondence of the results of case file reviews with subsequent amounts of paid claims.

373. No questions appear to have been asked about underlying documentation within the Syndicate pertaining to these matters, and it is now known that the Syndicate did not create and retain any such documentation. From the contemporary documents it is apparent that KPMG had many meetings with ESML employees, including Mr Morgan himself, and Mr Taylor spoke in evidence about a large number of further meetings, which were not documented, but there is no evidence that the matters referred to above were discussed and explored. We stress that insistence on proper documentation and full particulars of the process was far from an arduous task. In his oral evidence Mr Taylor accepted that he "did not have too much knowledge" of the "intensity" of file reviews, and, to the extent that he considered the matter at all, believed that it was based on ESML's "instinct" as to how much of the case reserves needed to be looked at, in each instance relying upon [...] to make the necessary

investigation and establish the accuracy and completeness of the relevant data. In other words there was no real engagement with this part of the Syndicate's activity.

374. Mr Simon Salzedo QC, on behalf of KPMG, in closing, accepted that KPMG was unaware of the so-called "Morgan File Review Process", in particular that KPMG was unaware that file reviews were conducted by reference to a predetermined target, the size of which varied in accordance with the Syndicate's position in the underwriting cycle. That "core vice" was not a matter known to KPMG. However, Mr Salzedo necessarily contended that "there was nothing that placed KPMG on notice that file reviews (which were an entirely normal feature of the insurance industry) were conducted by ESML in that manner".

375. To support that contention, Mr Salzedo pointed to the fact that Syndicate 218 had a long history of setting very prudent estimates giving rise to negative IBNR. He referred to audit work that was undertaken in relation to the setting of case estimates which, he contended, covered the risk of manipulation in relation to case reserves. KPMG undertook, for example, audit work in relation to the IT system to ensure that underlying claims data held on the RTM system was accurately reflected in the general ledger on the Sun system which was used to populate the financial statements. Walkthrough tests were undertaken in order to understand, and document the understanding of, the processes of updating case files. In each year KPMG undertook claims testing of 175 claims files (25 claims in 7 classes), which were designed to test whether the claims reserves were appropriately updated as new information about the claim was received.

376. Furthermore, [...], as Syndicate actuary, was well aware of the existence of the file reviews and had made specific allowance in its calculation of the outstanding claims provision. Mr Taylor said in evidence that so far as he was aware at the time KPMG was aware what file reviews had been taking place and the evidence from those reviews had been shared with the consulting actuaries. [...] could cross-check what ESML was telling it about file reviews by a review of the claims triangles, and any adjustment as a result of a case file review would be reflected in that claims data. [...] knowledge of and allowance for file reviews was reflected in [...] valuation reports.

377. The KPMG Respondents laid great stress on ISA 620, which addresses the situation where an auditor uses the work of an expert, in this case [...], the external actuary, emphasising, in particular, the following provisions:

> "*12. The auditor should evaluate the appropriateness of the expert's work as audit evidence regarding the assertion being considered. This will involve evaluation of whether the substance of the expert's findings is properly reflected in the financial statements or supports the assertion, and consideration of:*
>
> *Source data used*
>
> *Assumptions and methods used and their consistency with prior periods*
>
> *When the expert carried out the work*
>
> *Results of the expert's work in the light of the auditor's overall knowledge of the business and of the results of other audit procedures*

> ………
>
> *14. The appropriateness and reasonableness of assumptions and methods used and their application are the responsibility of the expert. The auditor does not have the same expertise and, therefore, cannot always challenge the expert's assumptions and methods. However, the auditor will need to obtain an understanding of the assumptions and methods used and to consider whether they are appropriate and reasonable, based on the auditor's knowledge of the business and the results of other audit procedures.*
>
> *15. If the results of the expert's work do not provide sufficient appropriate audit evidence or if the results are not consistent with other audit evidence, the auditor should resolve the matter. This may involve discussions with the entity and the expert, applying additional audit procedures, including possibly engaging another expert, or modifying the auditor's report."*

378. In addition, in both the 2008 and 2009 audit years, [...] relied on virtual file reviews to test the level of "redundancy" in a sample of claims as selected by [...]. For example, in the 2009 audit year, [...] undertook a stratified sample of 90 claims in the 2006 and 2007 YOAs in order to measure the "redundancy" for the purpose of arriving at an appropriate savings factor. For certain categories of claims, a virtual file review was undertaken on a comprehensive (as opposed to sample) basis, covering every claim. For 2009 [...] relied on a virtual file review for all outstanding excess claims for the 2004 YOA and for all outstanding very large claims for the 2000-2007 YOAs. Mr Taylor confirmed his understanding that the virtual file reviews "gave comfort to [...] about the level of redundancy"; and Mr Campbell, Executive Counsel's expert accountant witness, agreed that "on the face of the results of the file reviews" they gave significant corroboration that the incurreds [incurred claims] were reliable as far as the important question of redundancy in the key years was concerned.

379. However, in our judgment, the foregoing matters do not adequately address the nub of the relevant allegation. At any time there is an obvious risk that case reserves for outstanding claims may be manipulated with a view to seeking to influence the final reserve amount in the accounts, so as to affect the financial results of a syndicate. Again, in oral evidence Mr Taylor and Mr Hulse fully accepted these points. The incentive to manipulate the case reserves in this manner is obviously all the greater when the Syndicate is anxious that, after a long period of successful performance, it may be at considerable risk of having to report a loss or losses. Intense scrutiny and scepticism is called for in those conditions; and all the more so if there are clear warning signals that case reserves may not be reflecting the real likely incidence and extent of outstanding claims at a time when market conditions had changed materially and the Syndicate's performance was a matter of considerable uncertainty.

380. There were evident a number of highly important factors in 2008. KPMG, as Mr Taylor stated in evidence, already knew by that time that reserving in Syndicate 218 had become less "prudent" than had historically been the case. [...] was now changing its actuarial methodology for the third successive time, a development that called for special scrutiny and assurance that there was sufficient consistency in the reserving process, especially where as here the new methodology produced a reserve lower than the predecessor would have done. Furthermore, in 2007 the syndicate's capped claims (which comprised a greater part of the total estimate than excess claims) were based

on the Focus Model for 2005-2007. That model was based on paid claims development. By the middle of 2008 [...] had changed to a model based upon incurred claims development, in which the estimate for outstanding claims was of crucial importance. The scope for manipulation of that estimate was obvious.

381. In his oral evidence Mr Taylor was taken through these matters, and in each instance acknowledged their relevance and significance. However, both from the contemporary documents and from his general impression as a witness, we do not believe that at that time he brought any real analytical grasp or critical judgment to them, or asked himself whether the audit evidence was satisfactory. His mantra was that the audit was a "reliance" audit, and, so long as the KPMG Actuaries were satisfied with [...] work, nothing more was needed. We do believe, by contrast, again from the contemporary documents and his demeanour as a witness, that Mr Hulse did have an analytical grasp of the significance of these matters, but in the end reverted to the same mantra.

382. There were also clear warning signs. On the basis of available calculations by [...], actual gross payments from 30 June 2008 to 31 December 2008 were £99.99m, compared to expected payments of £78.22m, marking a deterioration of £21.77m. Net payments were £83.62m, compared to an expectation of £58.64m, marking a deterioration of £24.98m. The reason for the deterioration was unclear. KPMG produced a high level "benchmark" (appropriately weighted for the nature of the business) of the Syndicate's Motor Focus performance compared with that of other insurers in the UK market. That "benchmarking" showed that, historically from 1999, the Syndicate's relevant ultimate loss ratio was perceptibly higher than that of comparable insurers; in 2007 it had achieved parity, and in 2008 (with calculations driven of course by the 2007 result), the Syndicate's performance was, for the first time, markedly superior to that of comparable insurers. This remarkable comparative improvement might, as was noted in the analysis, have been attributable to market factors and or superior underwriting: another explanation, of course, was that the calculated ultimate loss ratio did not accurately reflect the actual performance of the Syndicate and, in particular, was based upon a material underestimate of outstanding claims.

383. In evidence, Mr Hulse candidly accepted that the analysis was taken as a "red light", but, thinking of the severity of subsequent warnings, changed the colour to "amber". From the evidence we do not believe that Mr Taylor independently considered the real risk that the extent of deterioration was being understated. We have already recounted the unsatisfactory circumstances in which [...] finally produced its actuarial report for 2009. [...] had managed to give the KPMG Actuaries certain raw data in time, but the KPMG Actuaries were unable to re-construct [...] conclusions from the data supplied. Nonetheless, the conclusions were accepted as "reasonable" for the purpose of supporting [...]'s half- year results as at 31 December 2008. It was wholly unclear from Mr Taylor's evidence how the KPMG Actuaries had reached that conclusion, or how Mr Taylor had satisfied himself that there was a basis for the conclusion.

384. KPMG were thereby placed in a delicate position; if subsequent, better informed and more rigorous scrutiny of the [...] calculations raised awkward questions, there was a risk that the questions would not be addressed with the scepticism and focus required, lest KPMG might have to explain to [...] that, on more mature investigation, the half

year accounts for [...] had turned out to be somewhat questionable. In any event it was clear that [...] was experiencing real difficulty in finalising its actuarial calculations for 2008, suggesting to a duly sceptical auditor that the issue of adequate reserving now merited even more intense consideration.

385. A key assumption for the 2008 audit (and also for the 2009 audit) was that the adverse trend observed in the paid claims development (as against incurred claim development) was attributable in significant part to "acceleration" and "leakage". For reasons explained below, we do not believe that KPMG as auditors adequately addressed that key assumption. In any event, the uncertainty inherent in that assumption was a further factor that called attention to the need to ensure that the data provided by ESML regarding case reserves, including file reviews, was consistent and reliable.

386. Particularly with that background, KPMG was required to look carefully at the process of case file reviews, given its significance in the final analysis of reserves, and to be confident that it had sufficient audit evidence, including proper documentation, as to how case file reviews were conducted and as to the justification for the substantial amounts of case reserves that were in fact being removed through that managerial process.

387. As to the specific matters mentioned by Mr Salzedo QC (see above), first, auditing the IT system was of no value so far as case file reviews were concerned, because the auditor did not thereby learn anything about case file reviews, and the data in the system was no substitute for specific and detailed information regarding such reviews. As to "walkthroughs", there was no "walkthrough" of what for present purposes was the relevant process, namely, case file reviews; and, as Mr Wilson, the expert accountant on behalf of KPMG, accepted, KPMG learnt nothing about case file reviews from any "walkthrough" that it carried out. As to the sample "testing", Executive Counsel was highly critical of the "testing", but for present purposes it is sufficient to observe that the "testing", whatever its real purpose, was in no way designed or performed so as to identify whether a claim had been subjected to a file review and what had been the result of any such review. None of the sample tests recorded any adjustment by reason of a putative file review, and the structure of the test did not provide for any such record. It can only be inferred that claims "testers" were not instructed to seek to note, and record, the incidence and amount of any case file review. The "tests", therefore, provided no audit evidence on the critical matter under consideration.

388. As to [...], the Syndicate actuary, [...] made plain in its relevant reports that it relied upon the information provided by the Syndicate. [...] did not audit or verify the accuracy of the data provided by the Syndicate. As far as can be seen, [...] did not investigate thoroughly, or indeed at all, the process by which case file reviews were conducted, or call for full particulars of precisely what claim files had been reviewed, of the basis for such review, and of the amounts of reserve removed in respect of each file. We have considered this issue at greater length above. It is correct that [...] knew that case file reviews took place, and sought to take them into account in its actuarial calculations. However, that demonstrates the significance of case file reviews to the actuarial work of [...], and emphasised the need for proper audit of the whole process of case file review. There was no such audit. The Syndicate did not create and retain proper documentation regarding the process. KPMG did not enquire

whether there was any such documentation and, if there was none (as was the case), insist on its creation and retention. KPMG made no enquiry at all as to the basis upon which the Syndicate (through its directors, Messrs Morgan and Josiah) was removing very substantial amounts from the case reserves through the relevant process, so that it would be in a position to satisfy itself that the method employed in fact was a proper one, and as such furnished satisfactory evidence that the amounts shown in the case reserves could prudently be relied upon.

389. ISA 620, upon which KPMG relies, explicitly recognises that the auditor must consider the source data that is used by an expert, and must consider the results of an expert's work in the light of the auditor's overall knowledge of the business and of the results of other audit procedures. The essential assertion being considered for present purposes was that the case reserves represented a reliable estimate of the Syndicate's outstanding liabilities at the reporting date, and for that purpose were being properly estimated, with case file reviews being conducted on proper and consistent principles. KPMG knew that [...] did not "audit" the source data provided by the ESML, including the source data for case reserves. Mr Taylor and Mr Hulse knew that the KPMG actuarial team also relied, indirectly, on the source data provided by ESML, and understood the importance of that data to the actuarial work of [...] and to its own actuarial team in its review of the reasonableness of [...] conclusions.

390. The relevant auditing of the case reserves, including the case file reviews, involved no special expertise. It was a straightforward matter to ensure that ESML created and kept proper records of case file reviews, showing specifically how the reviews influenced case reserves. A sound knowledge of the business was sufficient to allow KPMG to gain an understanding of the process and to take the necessary steps for auditing the process. However, nothing was done to ensure proper record keeping, and Mr Taylor showed practically no curiosity as to how Mr Morgan was orchestrating the case file reviews and how they might be influencing case reserves, notwithstanding that this was, and was recognised to be, an area of Significant Risk. Mr Morgan was no doubt alive to this lack of curiosity, and he no doubt became increasingly confident, until the very end, that the methodology that he employed, and the results that it achieved, would not be questioned or challenged by KPMG. As a consequence he enjoyed an extraordinary degree of control over this aspect of the business, largely free from any outside scrutiny, to the detriment of the efficient and proper conduct of the financial affairs of the Syndicate.

2009 Audit

391. It appears to us that the factors that we have mentioned in regard to the audit failure for 2008 became very substantially exacerbated during the 2009 audit.

392. A starting point might appropriately be the email of 24 July 2009 from [...], a senior KPMG actuary (see paragraph 169 above). The email followed a conversation with [...]. It does appear, quite astonishingly, that [...] was learning for the first time about the Syndicate's case file review process. What he was told appears very sketchy, and, given what is known of the file reviews that in fact had already taken place in 2008 and 2009, significantly incomplete. However, [...] did recognise the effect that file

reviews would have on the IBNR "going forward", and presciently warned that the incidence of file reviews (as he believed them to be) would leave KPMG *"with only limited belief in the patterns of incurred claims development data"* (emphasis added). No steps, however, were in the event taken to obtain full and detailed information about the process of case file reviews, or to ascertain precisely if, and how, Mr Morgan might continue to orchestrate further case file reviews, as in the event he did.

393. The process of case file reviews was highlighted in other communications, but no necessary steps were taken to obtain full and detailed understanding of the process. For example, on 20 January 2010 Mr [...] informed Mr Hulse and Mr Taylor that Mr Morgan was seeking to "force" 2007 [YOA] to break even, and that he (Mr Morgan) believed that *"he [had] pushed [...] quite hard [on the calculation of reserves]"* [a probable understatement given everything that is now known]; that [...] had found it hard *"to review the numbers",* observing that *"the outstanding [claims] position can move through the various forms [unspecified] of file reviews that take place."* Mr Hulse did correctly comment that "this is very dangerous territory", and in evidence accepted that by this point the warning lights had definitely shifted from amber to red. By then Mr Hulse had spoken at a lunch meeting with Mr [...], who had recently re-joined ESML and was immediately concerned with the cash position and the risk that the reserves might be inadequate.

394. By 26 January 2010 the red light was close to blinding. On that date the KPMG Actuaries presented their "Actuarial Review" for [...]'s half year clearance. In evidence, Mr Hulse recognised that the KPMG Actuaries were in broad terms aware of the process of case file review, and perceived that the process raised further doubt about the validity of case reserves. On 22 February 2010 Mr Hulse made some very telling notes, in which he observed that *"05, 06 & 07 [YOAs]"* had not *"had a pruning like 2004 had"*. Of course he did not know – because the matter had not been properly investigated – that in both 2008 and 2009 very substantial amounts had been removed from the case reserves for 2005-2007 YOAs by reason of file reviews which, if not a "pruning" on the same scale as for the 2004 YOA, went well beyond a mere trimming.

395. KPMG knew by then that [...] calculations assumed that there was as much as 50 per cent "redundancy" in the case reserves, but that crucial assumption was not easy to reconcile with other information regarding the impact of case file reviews, a task rendered even more difficult by the absence of full and detailed information about such reviews.

396. It was also on 22 February 2010 that Mr [...], [...]'s group actuary, raised some very perceptive points about the manner in which reserves were being calculated, referring in particular to assumed amounts of "redundancy" in case files. There is no evidence that Mr [...]'s email was brought to the attention of KPMG, but it demonstrates that someone then looking carefully and critically at the position was able to highlight weaknesses and real concern about both the adequacy of reserves and the manner in which they had been determined. A few days later, on 26 February 2010, [...] did again highlight the uncertainties surrounding the assumed amounts of "redundancy", raising the question directly whether the assumption was unduly optimistic, expressing real concern about [...] work, and rightly querying whether acceptance of the assumption, on the information currently available, might not be *"just storing up trouble for ourselves [KPMG] in the future"*.

397. One of the important "red lights" that was flashing in this period was the apparent discrepancy between the amounts paid to meet claims and the amounts that had been expected to be paid, as well as, critically, the amounts estimated in the reserves to meet outstanding claims. On 13 January 2010 Mr Hulse, in graphic language, noted the extent of the discrepancy: *"Incurreds [incurred claims] look OK but paid are ghastly"*. Of course that discrepancy raised the obvious question whether the actual paid amounts in fact reflected a much greater deteriorating underwriting performance than was being assumed, and whether the amounts estimated in the reserves were sufficient to meet future payments and, in particular, whether the substantial amounts of assumed "redundancy" in the case reserves were properly justified. Mr Hulse in his oral evidence correctly described that as "an overwhelming issue".

398. This issue was highlighted in the presentation that [...] made in the meeting on 15 January 2010. If there had indeed been acceleration/leakage, as hitherto assumed, it might have been reasonably expected, ceteris paribus, that the [...] data regarding paid and incurred claims development would have shown, which it did not, some "flattening out", as the effect of acceleration/leakage diminished over time. A key assumption of course had been that the increase in paid amounts was substantially affected by acceleration/leakage. In his note of 22 February 2010, Mr Hulse observed that the paid amounts for 2007 would, on the relevant hypothesis, assume acceleration of some 18 months, a magnitude that would cast serious doubt on the hypothesis. Co-incidentally on 22 February 2010 [...], a senior KPMG actuary, drew attention to an apparent worrying inconsistency in the Syndicate's "story" concerning acceleration/leakage, and warned that acceptance of the latest version of the "story" would help the Syndicate to argue that the current amounts of paid claims did not evidence worsening underwriting performance. […].

399. At the same time the importance of the final reserve provision, and thereby the reliability of all the data, including the amount of case reserves, that informed that provision, was brought prominently to the fore. In a paper to the Board, Mr Morgan recommended that <u>no</u> margin should be added to the amount calculated, following [...] work, for reserves. That represented a marked departure from the established practice of the Syndicate, as KPMG recognised at the time. It could only be properly justified if there was complete confidence that the final calculation was itself a prudent calculation of the required reserves, with complete and reliable information regarding, inter alia, case reserves, which in turn necessitated complete and reliable information regarding the process and effect of case file reviews.

400. All these matters came to a head on 2 March 2010. We attach considerable weight to the very concerning issues raised by [...] in his conversation with Mr Hulse. [...] was a senior and very experienced actuary who, it appears, joined the actuarial part of the KPMG audit team specifically in the light of the common understanding that the 2009 audit of the Syndicate would be a particularly challenging exercise, given the trends that had already emerged relating to the Syndicate's performance, and the recognition that the Syndicate's unbroken profit record was by then in real jeopardy. [...] gave his opinion that [...] approach was *"very high level"*, an indication that individual matters of significance had not been adequately explored, and that the final analysis was not *"very realistic"*, an indication that [...], with his considerable experience and expertise, had limited confidence in [...] calculation of reserves. [...] believed that there had been *"non-routine culling of estimates"*, referring indirectly to the incidence of case file reviews. It is now known that this description was well founded.

401. However, it is clear that [...] was compelled to rely on inference. The Syndicate kept no proper record of case file reviews; the criteria for such reviews were clothed in mystery. KPMG as auditors had not insisted upon the creation and retention of proper documentation; and had not enquired at all as to the criteria employed by the Syndicate, or as to the precise timing and detailed effects of the case file reviews that had been carried out. From the contemporary documentation it does not appear that even at this late stage KPMG had a firm and reliable understanding of the process. [...] in sum was very worried about the inconsistency of claims estimation, and had no confidence in its consistency.

402. We note in this context that, although [...] was expressing deep concern, there was no proper written analysis of the nature and extent of those concerns, explaining what data he had considered, how precisely he had reached his assessment and stating what steps were now necessary to address them. Given the crucial importance of the matters raised, this absence of thorough written analysis at that point was highly unsatisfactory, but not untypical.

403. There was then the conference telephone call between [...] and the KPMG Actuaries. Two fundamental points arose from that call:

(1) the validity of [...] actuarial calculation of reserves depended critically on an assumed consistency in the incurred claims development; and

(2) [...] calculation would not "stand up" if the amounts of case reserves for 2005-2007 YOAs had been reduced by reason of case file reviews.

404. However, even at what might be described as the 59th minute of the eleventh hour, KPMG, for the reasons already stated at length, had no detailed information about the criteria for, and incidence and effect of, case file reviews. [...] and [...] did then speak to [...], but she gave materially incorrect information regarding the 2005-2007 YOAs. It is frankly astounding that, given the importance of the matters under consideration, no proper documentary material was readily to hand to show the true position. However, that astounding fact was, ultimately, due to KPMG's failure as auditors to ensure that the Syndicate created and retained such documentation.

405. On the morning of 2 March 2010 there was in truth a "black hole" at the centre of the whole reserving process for the 2009 YOA: it was not known how in fact Mr Morgan/Mr Josiah had carried out case file reviews in the relevant period; there was no proper documentation recording the incidence and effect of such reviews; and a critical assumption about 2005-2007 YOAs was dependent upon last minute oral communication with [...] (that in the event was materially incorrect).

406. We stress the informality of these final hours. There was no meeting of interested parties – ESML senior management, KPMG auditors and actuaries and [...] – thoroughly to discuss the crucial matters that were now called into question. There was no memorandum in writing to demonstrate how the issues, which had recently been raised, had been resolved to the satisfaction of both [...] and KPMG. There was no KPMG actuarial memorandum of the nature that had been delivered for the 2008 audit and that had clearly contemplated for the conclusion of the 2009 audit. Indeed there was no written note at all from the KPMG Actuaries, explaining upon what basis [...]'s concerns had been addressed and why, in the light of those concerns, [...] calculations of the appropriate reserves could reasonably be accepted.

407. We are sure that Mr Hulse, if not Mr Taylor, did appreciate that KPMG as auditors were confronted with a black hole. As we have already recounted, Mr Hulse sought to obtain sufficient light by obtaining an oral representation (later put in writing) from Mr Morgan as to the "consistency" of reserving by the Syndicate. In our judgment, that was wholly inadequate in the circumstances because:

   (1) whatever the true position, Mr Morgan as Finance Director responsible to the Board of ESML for the Syndicate's financial performance, had every incentive to give the assurance sought, with a view to gaining KPMG's audit support for accounts that continued, in a turbulent period imbued with significant uncertainty, to show a profitable enterprise. Put another way, could Mr Hulse reasonably have expected that, whatever the true position, Mr Morgan, placed as he was, would refuse to give the unqualified representation that was sought? The realistic answer can only be, No.

   (2) the representation was in very general terms, regarding "consistency" in reserves. The representation made no reference at all to the criteria that were employed for file reviews, or to specific amounts of case reserves that had been removed, or to the position regarding the critical assumption for the 2005-2007 YOAs; and

   (3) the representation was somewhat ambiguous. "Consistency" was not defined or particularised, and allowed Mr Morgan the opportunity to contest the intended meaning and scope of the representation, an opportunity that he has in fact sought subsequently to exploit.

   (4) in any event, an oral representation was not an adequate substitute for a detailed investigation and analysis of the critical matters that had been raised regarding the case reserves.

408. In the event the Actuarial Sign-off for the Syndicate was sent on 30 March 2010. That document is extremely brief, and not in the detailed format that had been followed in previous years. It is clear from the document that the KPMG Actuaries were placing great, if not determinative, weight for their conclusion in respect of the reasonableness of [...] work on the representation made by Mr Morgan to Mr Hulse on 2 March 2010. In our view, for the reasons stated, that was wholly inadequate.

409. For these reasons we find that KPMG's failure, both in the 2008 and 2009 audit in respect of the whole process of case file review did not meet the following standards:

   (1) ISA 200 (Objective and General Principles Governing an Audit of Financial Statements):

   KPMG did not bring sufficient professional scepticism to the task of considering the audit evidence in relation to the process of file reviews. KPMG relied unduly on management information and representations relating to that process, without critically considering whether management had incentives to present information that was incomplete and biased, and to insist both on obtaining full and particularised detail of the process, and on eliciting a proper understanding of the process. The failure is graphically demonstrated by the fact that at the eleventh hour in March 2010 Mr Hulse fell back on an oral representation from the Finance Director of ESML that was without

definition and ambiguous, in circumstances where KPMG had wholly inadequate information concerning case file reviews and insufficient understanding of how the Syndicate carried out such reviews.

(2) ISA 500 (Audit Evidence): KPMG did not obtain sufficient appropriate audit evidence regarding the process of case file reviews to draw reasonable conclusions on which to base the audit. It is common ground that the risk of misstatement of reserves was both obvious and very serious in the context of the final accounts of the Syndicate's financial performance. The audit evidence relied upon by KPMG was neither sufficient nor appropriate, and KPMG simply failed to obtain sufficient and appropriate evidence about the accuracy and completeness of the information regarding the Syndicate's reserves.

410. Allegations 11 (2008 audit) and Allegation 19 (2009) are therefore established. Allegations 5 (2008) and 13 (2009) are also established.

Allegations 6 and 14: Failure to adequately evaluate sample results: Breach of ISA 530, paragraph 54

411. Executive Counsel alleges in effect that KPMG's testing of samples of 25 claims files both for the 2008 and 2009 audits revealed many instances of the case reserves being significantly less than the amounts ultimately paid, indicating that controls over case reserves were not operating effectively. Mr Campbell, the expert accountant for Executive Counsel, carried out an analysis of KPMG's testing. KPMG contends that the tests were ones of operational controls, to test whether claims handlers had applied the correct procedures in setting the reserves and setting payments, in particular whether the claims reserves had been adjusted as new information about the relevant claim came to light. The allegations were premised, it is argued, on an erroneous basis that the purpose of the test was to test the sufficiency of reserves on each claim tested.

412. Mr Wilson, the accountant expert for KPMG, pointed out that in a number of cases, the amount of the reserve significantly exceeded the total sum paid on the particular claim, and that, mathematically, the amount of under- and over-reserve tended to "net out" to a more or less equal total, showing that in the round there was not systematic under-reserving.

413. Mr Wilson also stated that the sample testing would not be an appropriate means of assessing the reliability of the case reserves generally, as was implied by this Allegation. The samples were relatively small and they had not been designed with such a broad aim in view. It appears to us that that matter is essentially an actuarial one, and Mr Lee, the expert actuary for KPMG, did not express a view on it. At first sight, however, Mr Wilson's point does seem to have some force.

414. In principle, it might be thought that an appropriate, but simple, way of testing the adequacy of case reserves generally would have been to compare the actual or estimated total payments in respect of a class of business for a relevant development

cycle against the cumulative case reserve and payment for each development period, to see whether the case reserve was higher or lower in that period than that required to ensure the total claim would be met. If there was an excess or shortfall, it might also be possible to see whether there was any underlying pattern revealed by the data. From the evidence it seems that [...] from time to time did carry out such a retrospective exercise, to assess the extent to which its estimates of reserves reflected the final outcome, but it is unclear whether this was done routinely. It does also appear that [...] made calculations of assumed "redundancy" in case reserves, critically in respect of the 2005-2007 YOAs (see below). The basis of the calculation is not readily evident; and it is unclear whether the KPMG Actuaries specifically reviewed that aspect. However, Executive Counsel does not criticise the KPMG Actuaries on this point, and would not be in a position to do so without appropriate actuarial evidence.

415. Mr Wilson makes the further point, in relation to sample testing, that the test data did not record any file reviews. That indeed is the case. KPMG knew that case file reviews were taking place, but made no enquiry, or comment, about the absence of any evidence in the test data that would show the incidence and amount of any reduction in the case reserve by reason of such review. This point, however, relates to KPMG's lack of curiosity generally about case file reviews, a shortcoming that we have already stressed on several occasions.

416. In the light of the matters above we are not able to conclude that, in respect of the testing, KPMG fell short of any relevant standard, and cannot find that KPMG was guilty of any misconduct.

Allegations 7 and 15: Failure to adequately plan, specify and document the scope of work for the KPMG Actuaries: breach of ISA 300, paragraph 4; PN20 paragraph 126; and ISA 620 paragraph 11

417. Pursuant to PN20 it was incumbent on KPMG to agree in advance the nature and scope of the work to be performed by the KPMG Actuaries.

418. The nature and scope of the actuaries' work was agreed in substantially similar terms in the 2008 and 2009 audits. The work was identified in a work paper simply as: "Review [...] actuarial methodology and numbers"; and in a further document which referred to the involvement of KPMG specialists to assist in the evaluation of the work of an external expert, [...]. In his oral evidence Mr Taylor candidly agreed that, in substance, the planning document did not set out any particulars of the work that the KPMG Actuaries were expected and required to perform.

419. However, in our view, PN20 in terms requires more than a bare statement of the foregoing kind, merely reciting that an internal expert will be engaged to review the work of an external expert. Consistently with the express terms of PN20, the precise nature and scope of the work had to be specified in advance, so that both the core audit team and the KPMG Actuaries knew precisely what was required of them; and that the actual outcome of their work, which of course would also be specified, could ultimately be checked against the agreed plan. A proper plan of this nature would, in

our view, also be conducive to greater certainty and efficiency, with all those involved in the audit knowing precisely what was expected and what would be produced; and also to improved control and accountability, where all involved could see whether the steps taken conformed with the plan, and, if not, the reason put forward for any deficiency. Such a plan in this case could very usefully have identified the key assumptions that would be likely to be made by the external expert, in particular, the extent to which the external expert would be relying on relevant information provided by management. The plan could then have made clear whether or not the internal experts would be testing, or at least reviewing, such information for accuracy or reasonableness.

420. It is submitted by KPMG that it would have made no sense for the non-specialist auditors to lay down in prescriptive terms exactly what steps the expert actuaries should take, especially as planning is an iterative process and the actuaries and the auditors were engaged in dialogue on an ongoing basis as to the scope of the actuaries' work. However, PN20 does not at all preclude discussion between the core audit team and the expert as to the nature and scope of the work that should be undertaken. Indeed such full discussion at the planning stage is likely better to inform the core audit team about the nature and scope of the external actuary's work, and to lead to an improved understanding of that work as well as of its own expert's testing or review. The plan could also readily provide for variation or revision in the light of future knowledge or development.

421. In his evidence Mr Taylor said that at the time he did understand that it was important that the paid and incurred data provided to [...] should be accurate. We do not believe that Mr Taylor at the beginning of the 2008 and 2009 audits did fully grasp the need to ensure that the data in respect of incurred claims should be reliable. When he was asked about the significance of the difference between the amounts of paid claims as against the (lower) amounts of incurred claims, he did not, unlike Mr Hulse, appear to grasp the basis of the questions, leading to defensive answers to a very straightforward point. Asked also why there was not a specific risk identified of manipulation of core data, Mr Taylor took refuge in the fact that there was a minimal risk of the manipulation of <u>paid</u> data. However, that was inadequate.

422. A proper planning document would specifically have recognised that case reserves could well be manipulated, that case file reviews could well be an engine for such manipulation, and that the whole process needed to be adequately understood and audited. In his oral evidence Mr Taylor accepted that the "planning document" did not identify any of these matters and specify how they were to be addressed in the audit. Mr Taylor said that the audit team was almost always in "planning mode". But PN20 does not speak of "planning modes"; it required in terms a proper plan at the outset, whether or not it can be shown at the conclusion of the audit that relevant matters had been adequately addressed; and the expectation that relevant matters are likely to be addressed during the audit does not excuse the failure to have such a proper plan in place at the outset.

423. Both Mr Wilson and Mr Lee, who had considerable experience in working with, or as, actuaries in the Lloyd's market, stated that the kind of bare instructions given to the KPMG Actuaries in this case were commonly found at the relevant time, and at the time they would not have found KPMG's "planning" unusual.

424. Furthermore, they point out that the KPMG Actuaries did produce an audit memorandum on 2 February 2009, which documented in considerable detail the scope of their work, including consideration of [...] methodology and assumptions. This was evidence, they suggested, that, notwithstanding the absence of a mandatory and proper plan, both the core audit team and the KPMG Actuaries did for the 2008 audit at the outset understand the nature and scope of the contemplated work, an unsurprising inference in their view, given that the KPMG Actuaries had participated in, and carried out similar work, in earlier audits.

425. The full force of that point, however, is considerably undermined by the fact that, at the crucial point in early March 2010, the KPMG Actuaries provided no comparable audit memorandum, or indeed any document at all of such a nature. Such a document would have specified the work that [...] had done, setting out in full the key uncertainties, especially those that by then were deeply troubling both the core audit team and the KPMG Actuaries, and explaining in convincing terms why nonetheless the [...] results were a reasonable estimate of necessary reserves. A planning document, as required by PN20 and of the nature described above, would have highlighted the need for such a final audit memorandum <u>before</u> the core audit team could properly sign off the accounts and would have thrown into sharp relief the absence of such a memorandum at that crucial juncture. A proper plan would also have highlighted the fact that the "memorandum" eventually, and retrospectively, produced on 30 March 2010 did not conform to previous practice or expectations.

426. Executive Counsel, however, does not criticise the actual work output of the KPMG Actuaries, as such; and there is no basis, therefore, for concluding that any failure at the planning stage had a significant detrimental effect on the work actually performed by the KPMG Actuaries, as such.

427. We believe that the final conclusion on this Allegation in respect of the 2008 audit is finely balanced, and in all the circumstances we conclude that the failure was not so significant as to amount to relevant misconduct. However, at the outset of the 2009 audit it was known that the Syndicate's performance had continued to deteriorate, that reserving since 2007 had steadily become less prudent and that, given early warning signs, the audit would be very challenging. The importance of ensuring that data in respect of incurred claims should be reliable was, or should have been, well known. It was essential, in our judgment, to draw up a proper and up-to-date plan, identifying all relevant risks, and specifying what work would be done. No such plan was drawn up, a failure that in the circumstances was a significant falling short of what was required by the relevant standard, and which did amount to "misconduct".

<u>Allegations 8 and 16: Failure to adequately review and assess [...] work in respect of Syndicate 218: paragraph 27 of ISA 220; paragraphs 8 and 11 of ISA 540, paragraphs 2, 5, 12 and 14 of ISA 620; and paragraphs 193, 199 and 212 of PN 20</u>

428. In closing Executive Counsel submitted that the crux of Allegations 8 and 16 was the interaction between KPMG as auditor and [...] as external actuary of Syndicate 218:

<u>all</u> that KPMG did by way of audit work in relation to the [...] reports was, it is alleged, to rely on the actuarial memos and regard them and the [...] reports, in combination, as sufficient audit evidence in relation to the reserves.

429. We have already dealt extensively with that issue in reaching our findings on what we regard as the central Allegations, namely that KPMG failed to obtain a proper understanding of, and necessary information regarding, the whole process of case file reviews in the Syndicate; and that without such understanding and information KPMG did not have sufficient audit evidence to support the amounts of reserves appearing in the accounts. [...] relied on management information to perform its actuarial calculations; but there was a "black hole" in that information of which KPMG were aware, or should with necessary care and competence have been aware, and the requisite audit work was simply not carried out. We shall nonetheless deal with the specific matters that are mentioned in these Allegations, in respect of both the 2008 and 2009 audit. It should, however, be noted that Allegation 16, in respect of the 2009 audit, refers additionally and, in some respects, specifically to Mr Hulse, and attributes to him shared and in some respects primary responsibility for the core failure of that audit. We have already dealt extensively with his role in the 2009 audit, indicating, in particular, the many "warning lights" which presented themselves, and his recognition of them and his failure to appreciate, in the light of those warning lights and the other matters to which we have referred, that there was manifestly insufficient evidence to support the conclusion that the Syndicate's reserves were being adequately determined for the purposes of acceptable financial reporting. We deal specifically with the issue of Mr Hulse's individual responsibility for the core failure of the 2009 audit in more detail at paragraphs 486 – 495 below.

2008 Audit

430. In the light of Mr Campbell's review of the material referred to in Mr Wilson's report, and his withdrawal of his criticism of KPMG on this matter, paragraph 145(1) of Allegations 8 (for 2008) and paragraph 161(1) of Allegation 16 (for 2009) in relation to the "margin", were not pursued. The other matters are dealt with in turn below.

<u>(a) The alleged failure to address [...] assumptions about the acceleration of paid claims (paragraphs 145 (2) and paragraph 145 (3) of Allegation 8)</u>

431. It is alleged that KPMG failed adequately to address assumptions about acceleration of paid claims, in particular, to test or verify such assumptions, and provided its audit opinion for the 2008 year without having reviewed or insisted upon receiving the 2007 [...] Report or updated report.

432. It does appear that in 2008 there was a consensus of opinion that the claims handling changes introduced by [...] had led to a speeding up of claim payments. In November-December 2008 the audit team conducted interviews with [...], Mr Morgan, Mr Josiah

and a number of underwriting staff. The underwriters also believed that "leakage" was contributing to the deterioration in claims experience, although [...] did not accept that this was the case. For example, the meeting note with Ms […] said that *"claims were hitting the books and being settled earlier than in prior years"*. In his evidence Mr [...]corroborated that from his discussions with management in 2009/2010 there appeared to be a consensus that the changes introduced by [...] had accelerated and increased claims, and that their reversal should have the opposite effect, and he referred to discussions with [...], the Syndicate's in-house actuary, which supported that view.

433. At bottom, therefore, the putative "acceleration" depended upon management assertion, with some limited actuarial evidence from the 2007 [...] Report. This was a report that Mr Taylor did not recall reading, and that he would have treated in any event as "out of date" by early 2009. [...] had carried out the report within a relatively short time of [...]'s appointment. There is no evidence that [...] itself sought to undertake any actuarial work to test the management assertions. [...] in essence accepted those assertions.

434. Mr Lee, the actuarial expert for KPMG, described the management view as no more than a "hypothesis". It is interesting that Mr Lee noted that acceleration would at most have affected two calendar years [2007 and 2008] of development, and that none of the data that he reviewed "conclusively prove[d] or disprove[d]" this management "hypothesis". The latest quarter of the 2008 underwriting year showed "some signs" of acceleration, but he thought the better view was that the 2008 development was an "outlier", that is, presumably not consistent with any previously observed pattern, rather than indicating "acceleration" as such.

435. Given the relevant "hypothesis", not apparent from hard data or tested by any up-to-date actuarial assessment, both Mr Wilson (not an actuary) and Mr Lee say that, in the light of the relatively recent accepted change in processes, no conclusive or even meaningful work could have been done. We find that very surprising. The "hypothesis" assumed no more than a one-month acceleration, affecting two development years. It would seem at first sight that the paid development model or models could have been adjusted to allow for such an assumed "acceleration", with a view to ascertaining the extent to which that degree of acceleration would, ceteris paribus, affect the development of expected paid claims.

436. Furthermore, in 2007 [...] had been able to carry out a tentative analysis. On 24 August 2010 […] provided a review to ESML of the technical claim reserves as at 30 June 2010. An "important part" of the analysis was to investigate whether the speed of settlement had changed. The analysis showed that, for claims up to £5,000, there was no material evidence of "acceleration"; for claims between £5,000 and £35,000, there was evidence to suggest "acceleration" for the 2007 year (of one quarter) and for the 2008 year (one and a half quarters). However, the "acceleration" did not appear to have continued in 2009. For claims between £35,000 and £100,000, […] assumed there was acceleration of half a quarter for 2007 and 2008, but this did not appear to continue in 2009. For claims between £100000 and £1million (the level at which reinsurance was available), there was no evidence of "acceleration"; on the contrary, there was evidence of slowing down of payments. In her 10 August 2010 Report, Dr […] , the [...] actuary who was brought in to make a further analysis, found no evidence of "acceleration" during the relevant period.

437. In our view, in respect of the 2008 audit, this issue is finely balanced. On one view, the issue of "acceleration" was so central to the reserving exercise that it cried out for further work and analysis that KPMG as auditors should have recognised. On the other hand, the relevant process changes were relatively recent, and it might not have been wholly unreasonable to wait to see whether the putative "acceleration" would fade with appropriate reform of case processing and the passage of time. In these circumstances we do not believe that we have a sufficient basis upon which we could properly find that the relevant criticism could be sustained. However, we do make the following observations in respect of the present matter that have considerable relevance to the 2009 audit.

438. The trend of increasing payments during the relevant period was plainly extremely worrying, because, on one cautious view, the trend was potential evidence of a deteriorating underlying performance by the Syndicate, occasioned by possible market and other developments. Looking at the matter with some realism, it is clear that management within the Syndicate could be expected to emphasise the incidence and assumed scale of acceleration, in order to rebut apprehension about weaker underlying performance; and to give an assurance that a reversion to previous claims handling procedures would see a return to "normal" payment levels. Such emphasis and assurance had to be treated with considerable scepticism. In addition, the "hypothesis" rested entirely on management assertion, and it was not apparent that any independent actuarial work had been carried out to test the hypothesis, or at least to explain why such work was not considered feasible. Furthermore, given the discernible increasing payment trend, and the possibility, on a cautious view, that, contrary to the relevant assumption, the increase was being primarily driven by deteriorating performance, it was all the more important to be satisfied that case reserves were being maintained in a prudent manner that was calculated to ensure that reserves would be adequate. Claim file reviews systematically reduced these case reserves, and it was imperative for KPMG as auditors to have a proper understanding of the whole process of such reviews, including, of course the methodology employed and the incidence and extent of any such reviews. No such understanding was sought or achieved.

439. In that context we note a point made by both Mr Wilson and Mr Lee. They say that, if the management "hypothesis" were invalid, there would have been a discernible, and otherwise unexplained leap, in the incurred claims development. No such leap was discernible. However, for our purposes, that point begs a vital question, and rather misses the relevant aspect. [...] incurred claims development relied upon management information concerning case reserves. If, for any reason, that information was unreliable, and case reserves were significantly understated, the reliability of incurred claim development, and the validity of any inferences that might otherwise have been drawn from it, would be thrown into doubt. Of course, once that point is recognised, the significance of case reserving, and case file reviews, is highlighted.

(b) The [...] report (paragraph 145 (3) of Allegation 8)

440. This matter in fact seeks to extend the particular matter that we have considered above. We do not believe that the 2007 [...] Report alters our conclusion. On closer analysis the 2007 [...] Report identified two forms of acceleration, and claims leakage, that contributed to a potential increase in claim payments in the first 8 months of 2007. Other factors contributing to such an increase might reasonably have been expected not to recur, or recur to the same extent, in future years. Mr Taylor could not recollect whether he had read the 2007 [...] Report, and it is somewhat unclear whether other members of the KPMG audit team read, and applied their minds to, the [...] report in the relevant period, but we do not conclude that this adds materially to the particular criticism.

(c) Deterioration in the 2007 YOA (paragraph 145 (4) of Allegation 8)

441. The actuarial audit memorandum dated 2 February 2009 did identify the fact that ultimate claims on the 2007 YOA had increased by about £77m since Q2 of 2008, representing a 2.1 per cent deterioration. Executive Counsel alleges that KPMG and Mr Taylor failed adequately to consider these circumstances and their potential significance.

442. The actuarial audit memorandum in question recorded three reasons for the deterioration: the impact of price aggregators, the effect of credit hire agreements and the change in methodology used by [...]. The KPMG Actuaries undertook a "benchmarking" exercise for all underwriting years, including 2007, concluding that the 2007 ULR did not appear unreasonable, the [...] estimate of 84.6 per cent matching the 84.7 per cent "benchmark". The KPMG Actuaries applied a sensitivity analysis to test the change in [...] methodology, showing a quite small increase on the appropriate alternative method.

443. Mr Campbell, the expert accountant witness for Executive Counsel, drew attention to the important fact that, on [...] analysis, the selection of the ULR for 2007 was a "key" selection because it drove the ULR selection for 2008. The KPMG audit memorandum did specifically mention that important fact. It was not entirely clear to us what specific criticism Mr Campbell was making in this respect. He seemed to be saying in his oral evidence that there was now emerging a consistent pattern in the increases in the ULR for recent years, and that that pattern might suggest that the ULR ratio selected for 2008 would prove in the event not to have factored in the true extent of deteriorating performance by the Syndicate, notwithstanding that some deterioration was being recognised for the 2007 YOA and was being factored into the selected ULR for 2008. As an auditor, he said, he would have sought to probe further the reasons for the discernible deterioration, and to obtain further "comfort" on the assumptions underlying the actuarial calculation.

444. Mr Lee, the actuary expert for KPMG, noted that it is relatively common for there to be a significant amount of uncertainty when estimating the ultimate claims (and therefore reserves) for the most recent underwriting years, in the present case, 2007 and 2008. This would appear to accord with common sense. The estimate of final

claims for 2007, and particularly 2008, would be perforce heavily dependent upon projections of incurred claim development in previous more mature years. The conditions prevailing in those earlier mature years might prove materially different from those actually affecting the final outcome in 2007 and 2008. In 2008 the actuary might have limited knowledge of any relevant conditions affecting the actual results for that year, and, one year later, the actuary might well have better knowledge that then prudently requires an adjustment to be made. As Mr Lee also noted, however, it was important to keep this matter under close review. A continuing trend of worsening performance might suggest deeper concerns about the underlying soundness of the underwriting business and the adequacy of reserves to meet substantially increased claims.

445. The real issue for 2008, in our view, was the reliability of the model that the actuary was employing, once known changes had been appropriately taken into account. In the present case that returns again to the question of the reliability of management information concerning case reserves and the extent to which such case reserves had been systematically reduced by a process that was vague, opaque and wholly improper, for the reasons already stated.

446. Mr Campbell conceded in his oral evidence that, standing alone, this was not a “big point”, but was of significance, taking the audit as a whole. The KPMG Actuaries did specifically look at the relevant issue and, notwithstanding the worsening trend, did believe that the [...] selection of ULR had in 2008 adequately taken into account relevant matters that were known or reasonably estimated. In the absence of specific identification of the further enquiries that the KPMG core audit team should have made, we do not conclude that this particular matter supports the general Allegation 8.

(d) Actual over expected claims (paragraph 145 (5) of Allegation 8)

447. [...] prepared a report dated 27 February 2009, entitled “Valuation as at 31 December 2008”. The report was prepared for [...] group reporting. The report focussed on reserves using a different basis of measurement (Australian GAAP): for example, the figures in the [...] [...] report were discounted for the true value of money, and estimated the unearned liabilities in a different manner and included risk margins. Mr Taylor could not recollect whether he had seen this report, and it does not appear that the KPMG Actuaries had seen the final report before the date of the 2008 audit. However the report had been provided to them in draft. The report showed that on a gross basis actual payments to 31 December 2008 were £99.99m as against expected payments of £78.22m and on a net basis were £83.62m as against expected payments of £58.64m.

448. The allegation is that KPMG failed, or failed adequately, to take account of the report.

449. Whether or not Mr Taylor saw the report, or whether or not the KPMG Actuaries reviewed the final report, there is no dispute that by the end of 2008 it was well recognised, by Mr Taylor among others, that [...] projections of claims payments were diverging very substantially from actual payments. Mr Campbell, the expert accountant witness for Executive Counsel, made the obvious but important point that

such divergence was potentially a worrying factor. If [...] had factored acceleration/leakage into its projection of paid claim development, either it had not taken that factor sufficiently into account, or there were other factors, bearing on the underlying strength of the Syndicate's performance, that could explain the divergence. If acceleration/leakage had not been factored into the analysis, there still remained uncertainty about the extent to which the divergence reflected an underlying deterioration of the account. As part of the 2007 audit work KPMG Actuaries had carried out their own analysis of actual as against expected payments. KPMG Actuaries did not carry out any similar analysis for 2008, or for 2009, and the reason is unknown.

450. Presumably, if the audit had been properly planned the reason for this different approach would have become apparent. No [...] document explored the matter of the relevant divergence between expected and actual claims. Mr Lee may be right in his surmise that *"ultimate claims as at 30 June 2009 [with reference to the 2009 audit] were from models constructed during 2007, when the paid claims experience was more stable"*. If that indeed were the case, it may be that [...] attached no significance to the relevant divergence because, as Mr Lee also surmised, it could be explained by, for example "acceleration", which ex hypothesis had not been, and could not have been, factored into the "old" paid development model. However, that would simply be further evidence that [...] was heavily relying on the management "hypothesis" to explain the divergence between expected and actual claims payments. If that "hypothesis" were invalid, or materially exaggerated, the divergence was of potential concern.

451. We accept Mr Lee's evidence that, if KPMG Actuaries had addressed the matter, it would have added "flavour" to their review, no doubt because they could have explored the issue further. We also accept that the increase in paid claims over expected added "uncertainty" to the results, as Mr Lee indicated. However, in our view, especially against a background in which [...] might well be dismissing the divergence by reason of its belief in the management "hypothesis", the divergence potentially evidenced a risk that there was a substantial underlying deterioration in the account. This would point to a concern that the Syndicate's estimates of case reserves were not now adequately recognising that outstanding claims were, through such deterioration, substantially increasing. It was put to Mr Campbell that the unreliability of the paid claims worked to justify [...] decision to change to incurred claims development. But that was not the point that Mr Campbell was addressing.

452. In our view, the real significance of this matter is that it drew attention, as we have explained, to a risk that the Syndicate's estimates of case reserves were no longer adequately recognising a material increase in outstanding claims. It was all the more important, therefore, that KPMG as auditors properly understood, and had necessary information about, case file reviews that were calculated, with increased frequency, to remove substantial amounts from those case reserves. [...] change to incurred claims development, referred to in the present context, was not a "comfort", to use an expression employed many times at the hearing. That change <u>intensified</u> the importance of the factor mentioned: the estimates of case reserves was a significant element in the information provided to [...] for the purpose of using, as reliably as possible, the amount of outstanding claims in its model of incurred claims development.

453. Even if there had been an excuse for KPMG's failure in the past, this significant change in [...] methodology should have spurred KPMG into the necessary action, namely, properly to audit the whole process of case reserving, including case file reviews, at the Syndicate.

454. In our view, the relevant divergence between expected and paid claims was a highly important factor, a powerful "warning light', to use Mr Hulse's terminology. For the reasons explained, the divergence should have focussed critical attention on the case reserves and highlighted the need to ensure that KPMG had a proper understanding of how those reserves were set and in particular of the process of case file reviews. We therefore conclude that this particular under Allegation 8 is well founded. We also note that the matters set out above also give significant support to the conclusion that we have reached, for the reasons explained, in respect of the core Allegation 11 for the 2008 audit.

2009 Audit

<u>(a) Paid claims and claims "leakage" (paragraphs 161(2) and (3) of Allegation 16).</u>

455. On 27 January 2010 KPMG made a presentation to the ESML Audit Committee of certain extracts from their actuarial review for [...]'s half year reporting. The data was for the period ending 30 November 2009 and had not been brought up to date for the year end. This was a preliminary piece of actuarial work. However, the KPMG presentation did again highlight the continuing adverse trend in the payment of claims. That in turn put in doubt whether the expected ultimate loss ratio set as at 31 December 2009 would accurately represent the actual performance of the Syndicate for the relevant period. These uncertainties would, or certainly should, have caused concern. Given that [...] was now employing a model of incurred claims development, such concern made it all the more important that the process of case file reviews was properly understood and audited by KPMG.

456. Mr Lee in his statement made two significant points relating to this matter. First, the KPMG Actuaries received and reviewed a […] note, which referred to work performed by the Syndicate to "verify" that there was an objective basis to support the management "hypothesis". However, we do not accept that the work was either objective or confirmatory of the "hypothesis". It is clear from the contemporary documents that by this time, and indeed well before, Mr Morgan had become a determined advocate, not only of the "hypothesis", but of any points that would serve to lower [...] estimate of necessary reserves; against a background in which the Syndicate's 40-year record of profitability was plainly under considerable threat. Mr Morgan had a clear incentive to find, or interpret data, that would confirm the pre-conceived management "hypothesis" of "acceleration". The particular exercise of "confirmation" needed to be treated with exceptional scepticism. Furthermore, both Mr Wilson and Mr Lee stated several times in their evidence that "acceleration" could <u>not</u> at that point in time be objectively tested with any real degree of rigour. Mr Lee

also said that he had seen no data in the papers that he had reviewed which demonstrated "acceleration". It also appears that the validity of the exercise turned on an assumption that the level of relevant claims would sufficiently replicate the level of similar claims in 2004, an assumption that raised questions. The results appeared to show that 2007 was 18 months ahead of 2004 in its paid claims development, when the anecdotal evidence of the ESML management in 2008 was that [...]'s process changes had sped up payments by one month. Finally, as Mr Lee confirmed, the "hypothesis" on any view was valid for only 2 years – 2007 and 2008; showing that 2007 had "acceleration" in its first year of development would not sufficiently explain why the actual payments in respect of 2007 YOA were not slowing as the effects of earlier putative "acceleration" would reasonably be expected to weaken. We refer again in this context to the […] review of August 2010 that showed little, if any, acceleration during this period.

457. Secondly, Mr Lee referred again to the more favourable development of the incurred claims development, and we repeat our earlier observations on that matter.

458. In our view, on the evidence that we have seen, at the conclusion of the audit in 2010, the incidence and extent of "acceleration" rested entirely on management assertion and manifestly required much further investigation and analysis than it received at the time.

459. As to "leakage", Mr [...] (the new head of claims at ESML) prepared a review of "claims leakage" and, on a sample of claims, said that the current management team "identified hard leakage averaging £1500 per claim file". Interviews conducted by KPMG in November/December 2009 gave some, if not unanimous, support to the view that claims "leakage" had occurred and, as a result of management and process change, was expected to reduce. This matter was discussed between [...] and KPMG. In calculating the ultimate loss ratios for 2008 and 2009 [...] built in an assumption that the paid amounts were greater because of claims "leakage", and therefore made an adjustment on the assumption that future "leakage" would be less. An allowance was made in respect of the 2008 ULR of 6 per cent; and a further 3 per cent in respect of the 2009 ULR. KPMG performed sensitivity analysis, concluding that the assumption had less than 5 per cent effect on the ultimate claims.

460. However, in our view, the position regarding "leakage" remained wholly unsatisfactory. […] We have seen no independent critique of Mr [...] work, such as to provide confidence in its conclusions. […]. It is notable that in late February 2010 [...] recorded a "certain backtracking" on the "acceleration" issue: he was then being told that speed of payments was not being reduced. [...] observed that what he was then being told was not consistent with previous accounts. If the new version were accurate, it would be unclear how a putative continuing speeding up of claims was consistent with reduced leakage (that seemed to depend on a slowing down of payments).

461. This last episode well illustrated the risks involved at this stage of events in relying on statements or purported "proofs" by management, that had not been corroborated by independent and objective analysis of relevant hard data.

462. The general allegation is that KPMG "failed adequately to review and assess [...] work", and, in the present context, failed in effect to do more audit work specifically in relation to the management "hypotheses" regarding "acceleration" and "leakage".

We have shown that each of the management "hypotheses" materially added uncertainty to the task of establishing the final reserves. In the light of concerns regarding "acceleration" [...] had moved to an incurred claims development mode. That change in methodology might not have been justified if either or both of the "hypotheses" were unfounded. However, the change of model drew, or ought to have drawn, heightened attention to the question whether the Syndicate's estimates of case reserves were reliable, and that in turn made more urgent and important the task of fully understanding, and ensuring proper documentation of, the whole process of case file reviews. We believe that, for the reasons explained, this issue had become of such central importance for the 2009 audit that the failure to address it appropriately was a serious failure, and that the particular matter which is subject to criticism is well founded.

(b) The lunch with Mr [...]in early December 2009 and the observations by [...] on 2 March 2010 (paragraph 161 (4) of Allegation 16).

463. We have mentioned these matters in addressing the core Allegation of KPMG's failure in the audit for 2009 to have sufficient audit evidence. Their central relevance is to provide significant support to the Allegation that there was insufficient evidence in respect of the Syndicate's reserving position.

(c) Deterioration in [...]'s ULR for the 2007 and prior years (paragraph 161 (2) of Allegation 16).

464. Following the [...] presentation on 15 January 2010, the KPMG Actuaries knew that [...] was projecting a further deterioration in the ultimate loss ratio, in other words, were projecting from their model of incurred claims development that the aggregate amount of claims payments for 2007 and prior years was expected to be significantly greater than that expected at the last valuation. [...] had factored in the level of actual claim payments seen from 30 November 2009 to 31 December 2009. In their "Actuarial Review" of 26 January 2010, the KPMG Actuaries drew specific attention to the "uncertainty" in the pattern of incurred claim development caused by case file reviews at the Syndicate, and potential "distortion" of the incurred claim development by another case reserving practice at the Syndicate. On that footing there was a real risk that the ultimate loss ratio might be greater than that projected by [...].

465. However, as we have noted on several occasions, KPMG had no proper understanding of, or necessary documentation concerning, the whole process of case file reviews at the Syndicate. KPMG knew that [...] had changed methodology from a paid claim development to that of incurred claim development, in which the effect of increased paid claims would be less significant in the calculation, but the reliability of case reserves would become paramount. The KPMG Actuaries were identifying real concerns about the reliability of the case reserves, and at the same time [...], the experienced actuary who had recently joined the team, believed that he saw evidence

of "non-routine" culling of reserves by reason of case file reviews (a correct assessment as it turned out), raising a serious and very troubling risk that the assumed level of "redundancy" in the case reserves was materially overstated in [...]'s actuarial calculation of reserves.

466. The relevant deterioration in the ultimate loss ratio must be seen in that overall context. Mr Campbell, although not an actuary, made in his report the obvious point that [...] could have cross-checked their results against the (then jettisoned) model of paid claims development, appropriately adjusted for assumed levels of "acceleration" and "leakage" (reinforced with any necessary sensitivity analysis in respect of those elements). Mr Lee acknowledged in his report that such additional modelling would have provided an "upper bound" for expected aggregate claims payments, and for the ultimate loss ratio. It would have highlighted the extent to which the more favourable results from the model of incurred claims development depended upon the validity of the management "hypothesis" concerning "acceleration".

467. Mr Lee observed that such an alternative approach would have *"captured the fact, if it was a fact, that the claims were not being paid faster, but that the underlying claims experience was worse"* [sc. than that more favourably shown by the incurred claims development] (our emphasis). Mr Lee went on to say that, if the management "hypothesis" were invalid, increased claims would have been discernible in any event in the incurred claims development. But he rightly recognised that the reliability of the incurred claims development, and hence the reliability of any inference that might otherwise be drawn from it, crucially depended upon an assumption that, in his words, "the case reserving philosophy" at the Syndicate was "stable". But at 2 March 2010 that was the very matter under the spotlight.

468. Mr Lee noted in this context that the Syndicate management had "advised" KPMG that KPMG needed to have no concerns about the stability of the case reserving philosophy. That observation neatly sums up the wholly unsatisfactory position on 2 March 2010. The inference is that Mr Lee, as an actuary, would have been content at that critical moment on this crucial matter with "management advice". Whether or not that would constitute proper actuarial practice, we firmly reject the view that the KPMG audit team, in the absence of any proper audit of the whole process of case file reviews, could proceed in that manner and rely on "management advice" given in the circumstances that we have explained.

469. In any event it is accepted that by the beginning of March 2010 none of these uncertainties was resolved. As at 2 March 2010, the day on which the accounts of 2009 were effectively signed off, the KPMG Actuaries had produced no further actuarial memorandum. On 2 March 2010 there was a conference call, but there was no written actuarial, or other appropriate, memorandum setting out in clear terms the nature and extent of the risks and uncertainties that had been identified, and how both the KPMG Actuaries and the core audit team had satisfied themselves that each of the risks and uncertainties had been adequately addressed, and that there was then sufficient audit evidence to support the reserves in the accounts. Given that KPMG had failed to audit the process of core file reviews, which had then been clearly identified as a key uncertainty, and was effectively dependent upon management representation, KPMG were not in a position to be so satisfied and lacked sufficient audit evidence in respect of a highly material matter. Given the importance of this

matter, and the clear and serious failure to address it, we find the relevant particular to be well founded.

(d) Actual over expected payments (paragraph 161 (5) of Allegation 16).

470. [...] prepared a report, dated 24 February 2010, on the Syndicate's Outstanding Claims Provisions. In the 6-month period ending 31 December 2009 actual claims exceeded expected claims by £76 million. It remained unclear why there was such a substantial divergence, why this trend was continuing to be shown, and, to the extent that assumed "acceleration" of payments was regarded as an explanatory factor, whether and to what extent, such an assumption could be regarded as reliable, especially with the further passage of time.

471. [...] had jettisoned the paid development model on the basis that the management "hypothesis" of "acceleration" was valid. It appears that actual claims experience, for the third consecutive year, was out of line with earlier projections of expected payments, calculated by the model that had been jettisoned. If the management "hypothesis" were valid, some degree of divergence might, ceteris paribus, be expected. However, if the "hypothesis" were invalid, or overstated, the continuing and increased divergence might well signal a serious deterioration in underlying performance, which would demand urgent and critical attention, especially in relation to the adequacy of reserves. Mr Lee recognised that the divergence increased uncertainty. We agree, and also observe that it yet again brought into focus the question of the reliability of the incurred claims development; and the need to be satisfied that management information regarding case reserves was accurate and complete, and to have a proper understanding of, and appropriate documentation in respect of, the whole process of setting and reviewing case reserves. Again this matter was highly relevant to the audit, there was a manifest and serious failure to address it in a satisfactory manner, and the relevant particular is well founded.

(e) Review of "virtual" file reviews (paragraph 161 (6) of Allegation 16).

472. [...]'s explanatory note dated 25 February 2010 set out the sampling process and results of the virtual file review that was conducted on a stratified sample of 90 files on the 2006 and 2007 YOAs. There was further discussion of the "virtual" file review between Mr Rakow and the KPMG Actuaries on 2 March 2010.

473. In respect of 2007 YOA the "virtual" file review showed an average "savings" percentage of 68 per cent. For 2006 YOA the average "savings" percentage was 69

per cent. These results, of course, supported the conclusion that there was substantial "redundancy" in the case reserves, and tended to justify the "savings" percentage used by [...] in its actuarial calculations. The "virtual" review was carried out exclusively by ESML caseworkers. It was ordinary practice for such reviews to be carried out by management and for such reviews not to be subject to any external assessment. However, it is somewhat unclear how the process of the "virtual" file review was fully consistent with what is now known to have been the actual file reviews for 2006 YOA and 2007 YOA. As at 30 September 2009 actual file reviews conducted in 2008 and 2009, are known to have removed almost £81 million from the case reserves for 2006 and 2007 YOAs. It is not entirely clear how the relatively recent removal of such substantial amounts nonetheless allowed ESML case workers to discover an average "redundancy" of 69 and 68 per cent, respectively, in the sampled claims for 2006 and 2007 YOAs. It is also unclear whether [...] knew that these amounts of reserves had been removed during the course of 2008 and 2009. We have seen no detailed evidence on virtual file reviews. The virtual file review in early 2010 is no more than a list of numbers, giving no indication as to the basis upon which the asserted "redundancy" had been estimated. In our view, the complete absence of any narrative behind the list of numbers substantially weakens confidence in the results of the exercise.

474. However, the real vice in this matter is that because the actual file reviews were not documented, properly or at all, it was simply impossible for KPMG to compare the results of any "virtual" file review with the results of actual file reviews, to question any inconsistency, and rigorously to assess the reliability of the continuing "redundancy" factor that the managerial sampling, entirely free of any independent scrutiny, was purporting to demonstrate in the summary form mentioned.

475. KPMG as auditors had no proper understanding of the whole process of actual file reviews, and had seen no recorded particulars of each of the case file reviews. There were none, and KPMG had not required such documentation to be created and retained. The assumed "redundancy" in the case reserves for 2006 and 2007 YOAs was a critical assumption in [...]'s calculations for the year ended 31 December 2009. [...] put faith in the "virtual" file reviews. But without a full understanding of the whole process of case file reviews, and in the absence of proper records of that process, it is highly questionable how much reliance could safely have been placed on the "virtual" file review. Given this background, KPMG, as auditors, could not properly have been confident that the "virtual" file review reliably supported the [...] analysis.

476. Furthermore, we do draw attention again to the fact that the "virtual file reviews" were carried out by ESML management. We do not suggest that caseworkers were specifically instructed to discover "redundancy", or that any targets were set for caseworkers to attain. We have no evidence to support such a conclusion. Nonetheless the exercise was carried out in a context where it was known by ESML management that [...] was assuming a very substantial amount of "redundancy" in the case reserves, and that such an assumption was crucial to the results of [...]'s actuarial projections, and accordingly, to the final reserve figure. If the outcome of the "virtual file reviews" turned out to show no significant "redundancy" in the case reserves, or materially less "redundancy" than [...]'s projections postulated, the entire incurred claims development might have been undermined.

477. All this was known, as well as the likely damaging consequences of such a scenario for the reporting of the Syndicate's financial performance. Against that background, we believe that, realistically, any managerial estimate of "redundancy", created at this critical juncture, demanded the application of a very high degree of scepticism indeed. There is no evidence of any such scepticism by either [...] or KPMG.

478. The relevant failure in the present context was the failure properly to understand the whole process of case file reviews so that KPMG would be appropriately positioned at a crucial point in early 2010 to question how much reliance could safely be placed on the "virtual" file review that had been carried out exclusively by ESML case workers, especially in the circumstances that we have adumbrated. The failure was serious and manifest; it played an important part in the core failure to ensure that there was adequate audit evidence in respect of the Syndicate reserving, and we find this particular well founded.

(f) The assumption regarding case file reviews for 2006 and 2007 YOAs, and the representation made on 2 March 2010 (paragraphs 161 (7), (8) and (9) of Allegation 16).

479. We have already dealt extensively with these matters, which again powerfully support the conclusion in respect of the core allegation. We accordingly find the relevant particulars to be well founded.

(g) Allegations 9 and 17: Failure to adequately document KPMG's and Mr Taylor's Review of [...]'s work in respect of Syndicate 218: ISA 230, paragraphs 2 and 9

480. KPMG advance two main contentions on this alleged failure. First, KPMG points to a very large volume of audit work that went well beyond a "review" of [...]'s actuarial work.

481. Secondly, KPMG employed its own actuarial team to review the reasonableness of [...]'s work. [...] were themselves relevant independent experts, and were responsible for the final figure for reserves that was included in ESML's accounts. The KPMG Actuaries, it is said, carried out a thorough "review" of [...]'s work, and were satisfied with its reasonableness.

482. However, in our view, these points do not provide an adequate answer to the Allegations. It was plain to all concerned that [...] relied upon management information. Case reserving was an important managerial function, and case file reviews an important feature of their function. Case file reviews were left wholly unaudited. KPMG had no proper understanding of them, and did not insist upon appropriate documentation, as already set out at some length. In short, there was no documentation in respect of the audit of the process of case file reviews, simply

because no such audit was carried out. These Allegations importantly support the core Allegation that there was a failure, amounting to misconduct, to audit an important management process, and as such are well founded.

(h) Allegation 10 and 18: Failure to adequately communicate audit matters to ESML: ISA 260, paragraph 11

(i) Allegations 12 and 20: Failure to disclaim, modify or qualify KPMG's expression of opinion on the financial statements of Syndicate 218: ISA 700, paragraphs 323, 37 and 38

483. These Allegations can be dealt with together. Executive Counsel accepts that they do not represent separate and independent allegations. They are dependent essentially on the central allegations of failure to have sufficient audit evidence. If the central allegation is proven (as we have found), these allegations do not constitute any further misconduct, but simply follow from the central adverse finding. On the alternative scenario, these allegations would simply have fallen away.

MR TAYLOR AND MR HULSE

Mr Taylor

484. Mr Taylor was the Responsible Individual for the Syndicate's accounts and, as such, he had the ultimate responsibility for signing off the accounts at the close of the 2008 and 2009 audits. We have found that KPMG did not have sufficient audit evidence to justify the giving of unqualified audit opinions at the close of both the 2008 and 2009 audits and, by giving such unqualified opinions, fell significantly short of the degree of skill and competence required by the applicable auditing standards. KPMG also fell significantly short in the manner specified by the further allegations that we have found to be established by Executive Counsel. These findings would not necessarily imply that Mr Taylor individually fell short of the applicable standards. However, Mr Taylor had individual ultimate responsibility for signing off the accounts and in relation to each of the matters forming the basis of Allegations. Acting with the requisite degree of skill and competence, Mr Taylor, as RI, would not have signed off the accounts, and would have ensured that KPMG did not fall short in the manner referred to in the relevant Allegations.

485. In his written and oral evidence Mr Taylor did not seek in any way to deny or diminish his individual responsibility, or to suggest that there was some systemic

weakness in the procedures over which he could not reasonably have been expected to exercise control. He accepted that if there were found to be significant shortcomings in the 2008 and 2009 audits, he was ultimately responsible. It is to his credit that he conducted his defence on that basis. However, the inevitable consequence is that Mr Taylor has individually significantly fallen short of the requisite standards and has committed relevant misconduct.

Mr Hulse

486. The position of Mr Hulse is more controversial. Mr Hulse was considerably senior to Mr Taylor within KPMG and had far greater accountancy experience, both generally and in relation to insurance enterprises. He became a partner in KPMG in 1990, with a special remit to focus on the insurance sector. From 1990 to 2007 he was head of Lloyd's Markets at KPMG, and from 2007 to 2009 he was Head of General Insurance Markets in the UK. From 1995 to 2002 he was the RI for the commercial syndicates of […]. In 1997 KPMG became the auditor of Syndicate 218, and in 2005 Mr Hulse became lead partner for the KPMG relationship with EIG which, following a management buy-out, had a large majority stake in Syndicate 218. When [...] acquired EIG in 2007, Mr Hulse became the lead partner for the KPMG-[...] relationship in the UK. Mr Hulse was RI both for EIG and [...]. He was not the RI for Syndicate 218, but in his capacity as lead partner he did have some involvement with, and oversight of, the audits of the Syndicate.

487. Mr Taylor joined KPMG in 1994. Working at KPMG in a junior capacity, he gained wide experience in the auditing of insurance enterprises, including those operating in the Lloyd's market. In 1998 he began working as an assistant auditor for Syndicate 218, and continued to work on the Syndicate's audits until 2007. In that year he was not part of the Syndicate audit team, but he did assist Mr Hulse in relation to the audit of [...]. In October 2008 Mr Taylor was promoted to Associate Partner in KPMG (becoming a full Partner in 2010), and was reassigned, now as RI, to the Syndicate 218 audit team.

488. As described earlier, for the 2009 audit Mr Hulse took the lead in relation to matters pertaining to reserving, including interaction with the KPMG Actuaries. Mr Taylor concentrated on the other aspects of the audit. In one sense the position was somewhat unusual, with the potential of confusing others, including even members of the KPMG Actuaries' team, as to whether it was in reality Mr Hulse who was "in charge" of the audit. Both in terms of seniority and experience, and also in the corporate hierarchy, Mr Hulse was by far the more eminent accountant. He was also leading on all matters relating to reserves, which was universally recognised as by far the most difficult, sensitive and contentious area of the audit. However, for the purposes of the audit of Syndicate 218, he was technically subordinate to the RI, Mr Taylor.

489. In the Formal Complaint (Allegation 16), Executive Counsel alleged that Mr Taylor and Mr Hulse both *"failed adequately to review or assess [...]'s work in respect of*

Syndicate 218", and set out at paragraph 161 (1) – (9) the grounds of that allegation. We have dealt with those paragraphs above. Paragraph 162 (1) – (7) set out matters *"further or alternatively, and specifically in relation to Mr Hulse"*. We have already dealt extensively with those additional and further particulars in our analysis of the core Allegation in respect of the 2009 audit and in our findings on specific particulars under Allegation 16. The outstanding question is whether, in the light of that analysis and findings, Mr Hulse's conduct can properly be regarded as relevant misconduct.

490. In the closing written submissions, Executive Counsel in effect drew a distinction between (1) a situation in which Mr Hulse acted as a member of the audit team, who fed his work up to Mr Taylor, with whom responsibility rested to take the final decision; and (2) a situation in which responsibility for the final decision on reserving effectively passed to Mr Hulse. Executive Counsel conceded that Mr Hulse would be liable for misconduct only if he acted in the second capacity. Executive Counsel submitted that Mr Hulse *"took over the partner function from Mr Taylor of supervising and directing the KPMG Actuaries' work, from around mid January 2010"*.

491. Executive Counsel, therefore, grounds the case against Mr Hulse by alleging that in effect Mr Taylor had "delegated" the role of RI vis-à-vis reserving matters to Mr Hulse and that Mr Hulse had accepted that delegation. It is contended that, in the period leading up to, and including the crucial day, 2 March 2010, Mr Hulse was in complete charge of the final decision to sign off the accounts. If Mr Hulse had not been satisfied that the reserves in the Syndicate's accounts were appropriate, Mr Taylor would have deferred without question to Mr Hulse's judgement and would not have signed off the accounts. Conversely, once Mr Hulse was satisfied, having in the event received Mr Morgan's oral representation, Mr Taylor did no more than accept Mr Hulse's opinion.

492. We believe that it is clear from the evidence, particularly the contemporary documents, that Mr Hulse, with his seniority and vast experience, was effectively directing matters in respect of all reserving issues, including interaction with the Syndicate (principally Mr Morgan), with the KPMG Actuaries (importantly, with [...]) and with [...], the external actuary. Mr Hulse made some important notes in relation to these interactions, to which reference has been made. Both Mr Hulse and Mr Taylor gave evidence that Mr Hulse kept Mr Taylor informed on relevant developments as the audit progressed, but there is very little contemporary material to show a real and substantial contribution by Mr Taylor in relation to the crucial issue of the Syndicate's reserves. Mr Taylor appears largely invisible in the decision-making process, particularly on the crucial day of 2 March 2010. It is significant that Mr Hulse, alone, confronted Mr Morgan at the end of that process. It was again Mr Hulse, rather than Mr Taylor, who gave the final confirmation to Mr Lewis, the audit partner and EQCR for the Syndicate audit (see paragraph 240 above). It appears to us that Mr Hulse wished in this crucial last phase of the 2009 audit to keep the reins tightly in his hands, not least because he had been the senior KPMG figure very recently concerned with the 2009 half year results, including the amounts stated for reserving purposes, of [...]; and no doubt he was anxious, in the light of current and worrying developments, about the prospect of ESML's results, crucially the reserve amounts, being required, on more mature reflection, to show a material deterioration from those that had, only a relatively short time before, been confirmed for [...]. We also believe

that it was only Mr Hulse who was in a position to give a plausible explanation to Mr Lewis that, notwithstanding those worrying developments, the accounts of ESML could properly be signed off.

493. Mr Taylor and Mr Hulse were consistent in their evidence that Mr Taylor, as RI, did retain ultimate responsibility for the 2009 audit, and that no part of his responsibility as RI had been "delegated" to Mr Hulse. Their personal view of this question must be given weight but it cannot be decisive. Mr Hulse also said that he did keep Mr Taylor well informed on relevant developments and did discuss with him the key features of the decision-making process on 2 March 2010.

494. However, the sparsity of contemporary written corroboration of such briefings, and the apparent lack of substantial active involvement by Mr Taylor, particularly on 2 March 2010 materially weakens Mr Hulse's case.

495. In our view, the ultimate question in this context is whether Mr Taylor brought any significant independent, critical judgment to bear on the final decision to sign off the accounts. That must be assessed in the light of what was actually happening during the final phase, and the Tribunal is not bound to accept the characterisation of their roles given by Mr Taylor and Mr Hulse, if such characterisation is not consistent with the circumstances viewed realistically and as a whole. If, in reality, Mr Taylor deferred without question to the opinion of Mr Hulse as to whether the accounts could be properly signed off, and Mr Hulse knew that that was the position, Executive Counsel's case would be established. We are prepared to accept, notwithstanding the unsatisfactory position regarding documentary material, that Mr Taylor was to a certain extent kept briefed, and that he was informed as to the key elements of the decision-making process on 2 March 2010. Given Mr Hulse's experience and his close involvement with the reserving issue, it was also improbable in any event that Mr Taylor would reject Mr Hulse's considered opinion on the outcome.

496. Considering the evidence as a whole, however, we conclude that Mr Taylor did not for his part seek to achieve any real grip on the critical issues that arose at the end of 2009 and the beginning of 2010 in respect of the Syndicate's reserving, and that he did not seek to bring any independent critical judgement to bear on that matter. In reality, he left the whole question of reserving to Mr Hulse; he left to him the task of liaising with the key participants, whether within the KPMG actuarial team, within [...], or within ESML, and left to him decisively and ultimately, the resolution of all outstanding matters concerning reserving. Again it is telling that the crucial confrontation with Mr Morgan and the subsequent briefing of Mr Lewis were conducted exclusively by Mr Hulse. There was in truth nothing that Mr Taylor could have materially contributed to those important interchanges. Mr Taylor was simply in no position to gainsay Mr Hulse's conclusion in respect of reserving, and could do no other that accept his opinion, notwithstanding his formal position as RI. In the terminology of Executive Counsel, Mr Taylor had delegated the relevant decisions on reserving to Mr Hulse, and Mr Hulse was well aware of the circumstances in which such delegation had been conferred.

497. It is on that basis that we find Mr Hulse individually responsible for the significant failures in the audit for 2009 that we have already identified, and as such guilty of relevant misconduct. For the avoidance of doubt we make clear that that conclusion does not affect the finding that Mr Taylor, as RI, had individual responsibility for the

audit as a whole, including for any work that Mr Hulse carried out in his "delegated" capacity. It was not suggested on behalf of Mr Taylor that our ultimate conclusion on Mr Hulse's conduct, even if adverse, would in any way affect the responsibility of Mr Taylor as RI for the 2009 audit (see in this connection paragraph 485 above).

F. SUMMARY: Misconduct

498. For the reasons given above, we formally find that, in respect of Mr Morgan, Allegations 1, 2, and 3 have been proved to our satisfaction. In respect of KPMG, Allegations 5, 8, 9, 11, 13, 15, 16, 17 and 19 have been proved to the extent previously set out in this decision. In respect of Mr Taylor, he bears individual responsibility for the foregoing Allegations, which are accordingly proved against him. In respect of Mr Hulse, he bears individual responsibility under Allegation 16, which is accordingly proved against him. As previously noted, Allegations 10,12, 18 and 20 are not alleged to constitute independent misconduct, but represent inevitable consequences if relevant Allegations are proved. The necessary condition precedent has been established in the light of our findings on the foregoing Allegations, and those consequences inevitably follow.

SANCTIONS

499. In this part of the Decision the Tribunal sets out the sanctions that it has decided to impose for the Misconduct of each of the parties that has been found in the preceding part of this Decision.

500. The applicable version of the Accountancy Scheme rules for present purposes are the rules dated 8 December 2014 ("the Scheme"). Under paragraph 9(8)(i) of the Scheme, the Tribunal may order "*such sanctions … as are contained within the schedule of sanctions at Appendix 1 to this Scheme as it considers appropriate*". Appendix 1 specifies the relevant sanctions both for Members, namely, Reprimand, Severe Reprimand, Condition, Exclusion, and Fine; and also for Member Firms, namely, Reprimand, Severe Reprimand, Condition, and Fine.

501. In determining the appropriate sanction, if any, the Tribunal must, under paragraph 3(ii) of the Scheme, have regard to the "Accountancy Scheme Sanctions Guidance" dated April 2018 produced by the Conduct Committee of the FRC ("the Sanctions Guidance"). The Sanctions Guidance took effect from 1 June 2018 and supersedes the previous sanctions guidance dated 1 June 2014. The Sanctions Guidance was revised in the light of the recommendations made by the Independent Review Panel Report into the FRC's Enforcement Procedures Sanctions dated October 2017 ("the Sanctions Report").

502. The Tribunal has had regard to the principles and considerations set out in the Sanctions Guidance, in particular to the matters set out in paragraphs 5, 7, 9, 10, 11-15, 17, 18 and 21 of the Sanctions Guidance.

MR MORGAN

503. We consider first the case of Mr Morgan.

504. In assessing the nature and seriousness of the Misconduct and in determining which sanctions might be appropriate, paragraph 21 of the Sanctions Guidance specifies 23 factors that the Tribunal may take into account. We consider in turn the following factors that we believe have potential relevance to Mr Morgan's case, adopting the alphabetical order of the Sanctions Guidance.

a: The financial benefit derived or intended to be derived from the Misconduct.

505. There is no evidence that Mr Morgan intended to derive any financial benefit from the Misconduct or that he did derive such benefit. It might be argued that the Misconduct enabled, or was likely to enable, the Syndicate to declare a greater profit, or lower loss than was, or might otherwise have been, the case, and that Mr Morgan benefitted financially, or was likely to benefit, from such an outcome. However, in our view, such a scenario would involve unfounded speculation, and turn upon excessively remote consequences. Executive Counsel does not rely upon factor a, and we proceed on the basis that Mr Morgan did not intend to derive any financial benefit from the Misconduct, and that he did not in fact derive any such benefit.

b: The gravity and the duration of the Misconduct

This factor should be considered together with the following factor:

j: Whether the Misconduct was isolated, or repeated and ongoing

506. The Misconduct took place over a relatively lengthy period of time, namely, three financial years (2007-2009), when Mr Morgan was Finance Director of ESML.

507. As to gravity, it is abundantly clear that the Misconduct was very serious indeed. We do not need to repeat our findings in detail, but we do emphasise the following points.

508. Reserving is at the heart of any insurance enterprise. As we stated, "*reserving was a crucial element in establishing and evaluating the financial performance of the Syndicate, and case reserves were a significant part of that process*" (at paragraph 289). Mr Morgan was during the relevant period the person principally responsible for the case file review process. For the reasons stated at length in our findings on Misconduct we concluded that the case file review process contained a number of "*highly objectionable features*" (see paragraphs 273-292), and in all the circumstances was "*wholly improper*" (see paragraph 316).

509. We also found that Mr Morgan did not give full disclosure of the file review process to the ESML Board, [...], and KPMG. We found that Mr Morgan promoted the lack of transparency, both to avoid scrutiny and to solidify his managerial discretion. He failed to ensure that [...] had a full understanding of what file reviews had taken place of the 2005 and 2006 YOAs in Q4 2009 (see paragraph 345), a failure that was in the circumstances "*especially egregious*" (see paragraph 358). Mr Morgan also made oral and written representations to KPMG in March 2010 (see paragraph 352) that were materially misleading.

510. Furthermore, the case file reviews materially affected the financial statements. [...] relied on the inconsistent and distorted incurred claims data in setting an amount for the reserves. We refer to this aspect also under factor c below.

511. Mr Hubble QC, on behalf of Mr Morgan, stressed that Executive Counsel did not allege that Mr Morgan acted dishonestly, or that he knew that his conduct violated applicable standards, or that he behaved in relevant respects without integrity. He pointed out that in any event Executive Counsel was precluded from advancing any such allegations by the Tribunal's ruling on 28 November 2017 (Day 2 of the Hearing):

> *".… In short, this is not a case of dishonesty, or lack of integrity, that is put against Mr Morgan, and, for the reasons that are cogently advanced by Mr Hubble, it would be unfair for the case to be converted into something of that kind, particularly in view of the different levels of sanction that would apply in each case" (transcript, at p.188-190).*

512. Accordingly, the Tribunal made no findings of dishonesty, guilty knowledge, or lack of integrity against Mr Morgan. No case was advanced that Mr Morgan knew that his conduct in respect of case file reviews might involve a breach of the applicable professional standards, but proceeded nonetheless to engage in such conduct, believing, for example, that it might be undetected, or do no harm, or not in the event discredit him, or simply through indifference. The Tribunal has made no finding, therefore, that Mr Morgan committed Misconduct "recklessly" within the meaning of the Sanctions Guidance.

513. Mr Morgan accepts that his Misconduct in relation to the file review process extended over a substantial period, and was serious, especially given that reserving was a crucial element in evaluating the financial performance of the Syndicate. Even at this stage, it is to his credit that he has to that extent acknowledged his Misconduct.

514. Mr Hubble QC, in this context emphasised that, firstly, Mr Morgan did not initiate the file review process: it was a process already in place when Mr Morgan took over. Secondly, Mr Morgan was not solely responsible: Mr Rakow of [...] and the KPMG

Respondents also committed Misconduct. Thirdly, as already mentioned, there was no relevant knowledge, lack of integrity or recklessness. Fourthly, Allegation 4, which was an important Allegation and had been fully developed by Executive Counsel at the hearing, was not in the event proven.

c: Whether the Misconduct caused or risked the loss of significant sums of money

515. As already mentioned, [...] relied on the inconsistent and distorted incurred claims data in setting an amount for the reserves. By 2009 the file review process had become seriously degraded. £126.5 million was removed for the 2005 to 2007 YOAs in 2008 and 2009 alone, in circumstances in which the 2009 SAA declared a profit of £15 million and the 2009 SUYA a slender profit of £0.2 million on the 2007 YOA.

516. By, at the latest, mid-2010 it was generally accepted that the reserves of the Syndicate were significantly inadequate. In June 2010 [...] made an announcement to the stock exchange recognising a one-off, pre-tax charge of about AUS $365 million. In 2010 an acceleration in claims had been observed, and it became apparent that the assumed loss ratios for 2009 and earlier years, and the reserves provided for those years, were materially understated. It is uncertain to what extent the observed deterioration and inadequacy of reserves were attributable to circumstances arising, or information ascertainable, only later in 2010, at a time after the period with which these proceedings are directly concerned. Any rigorous enquiry into that question might itself be hampered by the obscurity surrounding case file reviews, an obscurity engendered by the Misconduct that we have found. However, it seems to us that the Misconduct relating to case file reviews, which removed very large amounts from case reserves, at the very least carried the real risk that in the relevant period reserves would be materially understated, and loss ratios more favourably calculated, than would otherwise have been the case.

517. Furthermore, in setting prices for insurance business an enterprise must have regard to the expenses of operation, to the investment income on premiums received but not yet expended in claims, and, importantly, to the likely cost of present and future claims. Reserves should be calculated on a best estimate of future claims, so that the financial performance of the enterprise is fairly and accurately stated, and in order that underwriting decisions can be taken on a competitive but reasonably prudent basis. If the estimate of future claims is unsound, and the reserves materially understated, there is a grave risk that underwriting business will be mispriced, imprudently incurred, or inadequately reinsured. In the present case the Misconduct carried the real risk of masking the deteriorating performance of the Syndicate and of giving rise during 2008 and 2009 to the real risk of underwriting decisions that would not otherwise have been made. Mr Morgan indeed accepted that the Misconduct was likely to have contributed to the delay in Syndicate 218 becoming aware of the full extent of underwriting losses sustained in prior years of account. It was submitted that his actions "did not create underwriting losses". However, that submission did not address the real risks highlighted above.

e: The nature, extent and importance of the standards breached

518. The Allegations against Mr Morgan were for breaches of the Fundamental Principle of professional competence and due care and/or of professional behaviour under the CIMA Code of Ethics. Paragraph 100.4 of the Code provides, so far as is relevant:

> *"……*
> *c) Professional Competence and Due Care*
> *A professional accountant has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A professional accountant should act diligently and in accordance with applicable technical and professional standards.*
>
> *(e) Professional behaviour*
> *A professional accountant should comply with relevant laws and regulations and avoid any action that discredits the profession."*

519. These are clearly very important standards that set out the core duties of a professional accountant. Mr Morgan's Misconduct, including breaches of the applicable Lloyd's regulations, constituted a fundamental failure to comply with these standards.

f and g: Whether the Misconduct involved a failure to act or conduct business with integrity or was dishonest, deliberate or reckless

520. This factor has already been discussed (see paragraphs 511-512 above)

n: Whether the Misconduct adversely affected, or potentially adversely affected, a significant number of people in the United Kingdom

521. Mr Morgan accepted that the Misconduct had the potential to affect policyholders and [...]. He accepted that the Misconduct was likely to have meant that the underwriting losses were not appreciated sooner, but he denied that the Misconduct "caused underwriting losses".

522. We find, for the reasons already explained, that the Misconduct had at least the potential adversely to affect [...], its investors, and the Names on the Syndicate. We have also explained the potential adverse affect on the underwriting business of the Syndicate (see paragraphs 515-517 above).

r: Whether the Misconduct could undermine confidence in the standards of conduct in general of Members, ... and/or in financial reporting and/or corporate governance in the United Kingdom and/or in the profession generally

523. Mr Morgan accepted that the Misconduct could be said to undermine standards of conduct and/or financial reporting.

v: Whether the Member held a senior position and/or supervisory responsibilities

w: Whether the Member was solely responsible for the Misconduct

524. We take these factors together.

525. As Finance Director, Mr Morgan was responsible for "Reserving", which embraced the whole process by which the final amount for reserves was established. He was responsible for the accuracy of the financial reporting. He needed to ensure that the relevant processes produced accurate and complete financial information to the Board, [...] and KPMG. He also needed to ensure that ESML complied with the Syndicate Accounting Byelaw and the relevant Lloyd's regulations. As to the file reviews, we held that Mr Morgan assumed a prominent role and was the leading light in that process.

526. We have recorded that others were also responsible for Misconduct in relation to file reviews. However, we do not believe that the Misconduct of others significantly reduces Mr Morgan's individual responsibility. His was the primary role in relation to file reviews, and both [...] and KPMG were relying upon him to provide accurate and complete information. He did not do so, and as a result they did not know that the file review process suffered from the highly objectionable features that we have identified.

527. Paragraph 18 (a) of the Sanctions Guidance directs that the Tribunal should assess the nature and seriousness of the Misconduct by reference to paragraphs 20-24 of the Sanctions Guidance. Paragraph 23 states:

> *"Where determining the sanction to be imposed, a Tribunal will have due regard to the fact that sanctions have been …. imposed by another regulator or other authority in respect of the Misconduct or the events related to the Misconduct to ensure that consideration is given to the need to be proportionate, where other sanctions may address the purposes set out in paragraph 9 above."*

528. As a result of the Lloyd's proceedings Mr Morgan was made subject to the Notice of Censure set out in the Lloyd's Market Bulletin; and Mr Morgan undertook not to apply to be a director of a Lloyd's firm for three years from 14 March 2013.

529. Mr Hubble QC, on behalf of Mr Morgan, submits that, having regard to the further evidence filed by Mr Morgan for this stage of the proceedings, the Lloyd's proceedings and the Lloyd's sanction have had a marked detrimental effect on his career and life generally. There is, he added, a strong factual overlap between Allegations 1-3 and the Notice of Censure, and the Allegations in the present proceedings focussed on breaches of Lloyd's byelaws and regulations. In these circumstances, Mr Hubble contends, proper standards have been declared, steps have been taken to promote public and market confidence, Mr Morgan has been sufficiently sanctioned, and it would now be disproportionate if the Tribunal were additionally to restrict, for any period, Mr Morgan's ability to find work as an accountant in business, that being the inevitable consequence of a decision to exclude Mr Morgan.

530. This matter is considered at paragraphs 541-543 below.

531. Mr Hubble also submits that there has been delay, indeed unreasonable delay, in the FRC bringing these proceedings, and that the delay should be taken into account in the determination of the appropriate sanction. Delay, whether or not unreasonable, is not a factor specifically mentioned in the Sanctions Guidance but Mr Hubble submits that the Tribunal may, and should, consider all relevant circumstances, and delay is one of them. In this case the material events occurred in the period 2007 to 2010, and it was three and a half years after the start of the investigation, and four years after the referral by the FSA, before the FRC served, in October 2015, a Proposed Formal Complaint on Mr Morgan. This was not long before the expiry, in March 2016, of the three-year period of suspension imposed by Lloyd's.

532. In his written submissions, Mr Hubble put the point in the following way:

> *"He [Mr Morgan] has already been living with the consequences of his misconduct for the past eight years and the impact on his career, his livelihood and his family life is plain to see. Further, where he has found work, there is no suggestion that he has conducted that work incompetently or put any stakeholder at risk. Thus even if … this was a case where the Tribunal might otherwise have considered an order for restriction, preclusion or exclusion, the effectiveness of those sanctions has now been removed by the FRC's substantial delay."*

533. We deal with this matter at paragraphs 544-545 below.

CONCLUSION: Mr Morgan

534. As already observed, Mr Morgan accepts that his Misconduct was serious, and he recognises that he could not resist the imposition of a Severe Reprimand. However, on his behalf, Mr Hubble submits that a sanction of Exclusion from CIMA for any period would be disproportionate and unjustified.

535. We remind ourselves that the ability to exclude exists because:

> *"… certain Misconduct is so damaging to the wider public and market confidence in the standards of conduct of Members and in the accountancy profession and the quality of corporate reporting in the United Kingdom that removal of the Member's professional status is the appropriate outcome in order to protect the public or otherwise safeguard the public interest"* (Sanctions Guidance, paragraph 51).

536. It is also necessary to bear in mind:

> *"Where the Misconduct is fundamentally incompatible with continued membership of a Participant, exclusion is likely to be the appropriate sanction" (Sanctions Guidance, paragraph 53).*

537. In the light of that guidance, we believe that the nature and gravity of the Misconduct is a critical factor in determining whether Exclusion is appropriate and justified. We have set out in our findings of Misconduct our view of the seriousness of Mr

Morgan's Misconduct, and we have summarised our conclusions at paragraphs 508-510 above. At the expense of some repetition and abbreviation, we emphasise that Mr Morgan's failure to comply with his fundamental duty to act competently and diligently was at the top end of the scale of offending of that nature. He was Finance Director of ESML. He was responsible for all aspects of Reserving, a crucial function given both the central importance of reserves in the calculation of accurate and reliable financial accounts, and the scope for manipulation. Case reserves were an important element in the reserving process. Under his direction case file reviews were, over an extended period, carried out in an objectionable and wholly improper way, as explained in detail. Large amounts were in the final periods removed from case reserves through that process. Mr Morgan knew that both [...] and KPMG relied on him to act competently and diligently, but he did not disclose to them the full nature and scope of the case file reviews that he was orchestrating. At a critical point he made oral and written representations to KPMG that, on an objective analysis, were seriously misleading. We also found that the opaqueness of the file reviews rested on a conscious choice by Mr Morgan, to reduce the opportunity for external scepticism and challenge, and to strengthen his managerial discretion.

538. We fully recognise the force of Mr Hubble's submission that Mr Morgan was not dishonest, that he did not have the necessary knowledge to justify a finding of intentional wrongdoing, and that he was not reckless in the relevant sense. However, we reject the implicit contention that Exclusion would be justified if, and only if, one of those elements could be demonstrated. There is no such requirement under the Sanctions Guidance, rightly so in our respectful opinion. There will be cases where the nature and gravity of the failure to act competently and diligently is so serious that it falls within the terms of paragraphs 51 and 53 of the Sanctions Guidance, cited above, notwithstanding the absence of intent or recklessness. Having given the matter careful and anxious scrutiny, we conclude that in this case the nature and seriousness of the Misconduct must be marked by Exclusion. The Misconduct was such that it was "*fundamentally incompatible with continued membership of a Participant*"; and public confidence in the standards that govern the accountancy profession and in the quality of corporate reporting, and the public interest more generally, can be promoted only by the imposition of Exclusion in this case. For the avoidance of doubt we have considered whether any lesser sanction would adequately achieve those objectives, but, taking account again of the nature and seriousness of the Misconduct, we reject that possibility.

539. We consider also that, in the light of the foregoing, a period of Exclusion from CIMA of three years would be appropriate and justified, subject to any further relevant considerations. Any application for readmission after that specified period should not be automatically granted, but should be considered by the CIMA, having regard to all relevant facts and matters.

540. We must also deal with the two matters mentioned at paragraphs 529-533 above, namely, the significance of the Lloyd's proceedings and delay.

541. It is first correct, as Mr Hubble QC submitted, that there was some overlap between the Lloyd's proceedings and the present proceedings. The extent of the overlap is made clear earlier in this Decision (see in particular paragraphs 319-320, 325-326).

542. However, the focus of the present proceedings was both broader and more intense, involving a close examination, with the assistance of extensive expert evidence, of the nature and scope of file reviews more generally over an extended period; and of the impact of Mr Morgan's Misconduct both on [...] and also on ESML's auditors, KPMG. We do not believe that we could properly proceed, as we are in effect invited by Mr Hubble to proceed, as if Mr Morgan had already been comprehensively and effectively sanctioned by Lloyd's for the Misconduct that this Tribunal has found, following an exhaustive investigation of the process of file reviews during the relevant years.

543. Nonetheless we do recognize a degree of overlap, and the fact that the sanction imposed by Lloyd's did have an impact on Mr Morgan, particularly in the six-month period from 22 April 2013, as explained by Mr Morgan in a further witness statement. It may also be the case that as a result of the Lloyd's proceedings Mr Morgan was shut out of other more attractive employment opportunities, a matter that is inherently not susceptible to easy demonstration. In these circumstances we are concerned that the cumulative sanction should not be disproportionate and, with that in view, believe that the initially proposed period of Exclusion should be reduced to one of two years, constituting a significant reduction of one third of the period that would otherwise have been imposed. That significant reduction also gives credit for the fact that Mr Morgan had not previously been the subject of any disciplinary proceedings (excluding the Lloyd's proceedings which arose from the same events). For the avoidance of doubt we emphasise that in our view, taking account of the sanction imposed by Lloyd's and already served by Mr Morgan, a period of Exclusion of two years adequately promotes the objectives, recognised above, of public protection and of the public interest more generally.

544. As to delay, we note again that this is not a factor expressly mentioned in the Sanctions Guidance. We believe that delay could be relevant only in an exceptional and compelling case where, for example, (1) the FRC, without reasonable justification or excuse, had prolonged proceedings inordinately; and (2) as a result of such inordinate and unreasonable delay, the imposition of a sanction that would otherwise be justified was rendered disproportionate.

545. It is correct that these proceedings have extended over a lengthy period. However, we are satisfied, in the light of the evidence provided by Mr Rawlings, Senior Lawyer in the Enforcement Division of the FRC, that the FRC has not been guilty of culpable and inordinate delay. Furthermore, we are not persuaded that Mr Morgan sustained such prejudice by reason of the lapse of time that the proposed sanction would be disproportionate. On one view, if the present proceedings had concluded at a significantly earlier time, Mr Morgan might well not have achieved the kind of employment that he has in fact enjoyed since he left ESML on 30 September 2010. In any event, having considered the detailed evidence provided by Mr Morgan, it appears to us that, notwithstanding the lapse of time, he has, for most of the period since 30 September 2010, obtained employment with reputable employers in well remunerated positions. In these circumstances we cannot conclude that any prejudice sustained by Mr Morgan by reason of lapse of time would render the proposed sanction of Exclusion for two years disproportionate.

546. For the sake of completeness, we should add that we believe that the foregoing analysis has already covered all relevant points of aggravation and mitigation, and

that no further separate discussion on those aspects is required. We also should add that, in line with the Sanctions Guidance, we have considered other previous cases. However, like many of our predecessors, we have not found such cases particularly helpful. The central problem is that the facts and other material factors are likely to be significantly different, and considerable time and effort can be spent – ultimately without real advantage – in comparing similarities and differences to achieve what may prove to be an illusory coherence. Executive Counsel drew attention in particular to the case of RSA Insurance Ireland Ltd. However, without descending into the minutiae of that case, it might plausibly be argued that the failure, namely reporting in the accounts, without any cogent rationale, amounts of reserves that were lower than case handler estimates, and lower than those reported to reinsurers, was more egregious than that in the present case. On the other hand, Mr O'Connor's individual conduct in that case might be thought to have been substantially less culpable than that of Mr Morgan. We can see that consideration of other cases might give some comfort to a Tribunal that the proposed sanction is broadly in line with other not radically dissimilar cases, but we do not believe that it can in any way be a substitute for a detailed exploration of the actual case in hand.

547. Executive Counsel also submits that the Tribunal should impose on Mr Morgan a fine of £100,000, in addition to a period of Exclusion.

548. For reasons already given, we would have concluded that, given the nature and gravity of the Misconduct, a substantial financial penalty might well have been justified to achieve the objectives set out in the Sanctions Guidance. However, we have carefully considered the detailed evidence provided by Mr Morgan in his further witness statement as to his current personal and financial circumstances. We are satisfied on that evidence that Mr Morgan does not have the present means to pay a substantial fine, and that the imposition of any substantial fine would be likely to lead to imminent bankruptcy. Given the significant Exclusion that we are imposing, and the uncertainty regarding re-admission to CIMA, there is also real doubt about his future employment prospects. Executive Counsel accepts that, on the available evidence, Mr Morgan does not have the current means to pay a substantial fine, but urges us nonetheless to impose a Fine, submitting in support that Mr Morgan has been the author of his own precarious financial position.

549. We have already mentioned the sanction imposed in the Lloyd's proceedings, and the impact that such sanction had on Mr Morgan. The Notice of Censure is likely to have some continuing adverse effect on Mr Morgan's employment opportunities, and the Exclusion that we are imposing is also likely to have such an effect. In all the circumstances we do not believe that, to achieve the objectives set out in the Sanctions Guidance, it is necessary to impose on Mr Morgan a further sanction of a Fine. We should stress that we regard the present as an exceptional case. This case should not be treated in any way as a precedent by those in the future seeking, on the grounds of impecuniosity, to avoid imposition or reduction of a Fine that would otherwise be justified.

THE KPMG RESPONDENTS

550. We shall follow the same procedure as in the case of Morgan, considering each of the relevant factors in the Sanctions Guidance in alphabetical order, save where certain factors are closely related.

a: Financial benefit derived or intended to be derived from the Misconduct

551. None of the KPMG Respondents intended to derive financial benefit from the Misconduct, and no financial benefit was derived by reason of the Misconduct. KPMG did earn audit fees from the impugned audits for 2008 and 2009, but the amount of those fees was neither more nor less by reason of the Misconduct.

b: The gravity and duration of the Misconduct

j: Whether the Misconduct was isolated, or repeated and ongoing

552. It is abundantly clear from this Decision that the Misconduct of each of the KPMG Respondents was of a very serious nature. We do not believe that it is necessary to refer to our findings in detail, but we highlight the following points.

553. In essence, KPMG recognised that reserving at the Syndicate gave rise to the greatest risk of misstatement, and that case reserves, which were a very material element in the reserving process, were susceptible to manipulation. File reviews were an important feature of case reserves, and the KPMG Respondents failed to understand, and to audit, that process, in any adequate manner (see, in particular, paragraph 373). As we found, there was no real engagement with this part of the Syndicate's activity.

554. In respect of Mr Taylor, we held that he did not bring any real analytical grasp or critical judgment to material questions, or to ask himself whether the audit evidence was satisfactory, in other words, a complete failure of professional scepticism, and a failure of audit planning to assess the risk of material misstatement. We specifically pointed out that the task was not especially difficult and that a sound knowledge of the business of the Syndicate was sufficient to allow KPMG to gain an understanding of the process and to take the necessary steps for auditing the business.

555. That was the state of affairs for the 2008 audit. However, matters became worse for the 2009 audit. There were a series of "red lights", indicating increasing concerns about the Syndicate's reserves, which by January 2010 had become close to blinding. We referred to the position of [...], and stated:

> *"The Syndicate kept no proper record of case file reviews. The criteria for such reviews were clothed in mystery. KPMG, as auditors, had not insisted upon the creation and retention of proper documentation and had not inquired at all as to the criteria employed by the Syndicate or as to the precise timing and detailed effects of the case file reviews. From the contemporary*

documentation, it does not appear that even at this late stage KPMG had a firm and reliable understanding of the process" (paragraph 401*).*

556. We recorded that by the morning of 2 March 2010:

> *"... there was in truth a black hole at the centre of the whole reserving process for the 2009 year of account. It was not known how Mr Morgan and Mr Josiah had carried out case file reviews, there was no proper documentation regarding the incidence and effect of such reviews and a critical assumption about the 2005 to 2007 years of account was dependent upon last-minute oral communication with [...] that in the event was materially incorrect"* (paragraph 405).

557. It is important that we recall these findings because we believe that in his submissions Mr Salzedo QC, on behalf of the KPMG Respondents, did seek to some extent to downplay the seriousness of the Misconduct. It is correct that in many cases the very serious nature of the Misconduct is at once and with little explanation obvious. However, in our view, once the rather complex context of the present proceedings is fully understood, the very serious nature of the Misconduct is also plain and obvious. Mr Salzedo implied that Misconduct could properly be characterised at the upper end of the scale of gravity only if, for example, there were an array of failings affecting separate areas of the audit, or where the Misconduct involved wholesale audit failures in separate areas as well as lack of integrity. We reject that implication. In this case the area affected was at the core of the enterprise's processes, namely, reserving, and the audit failure was, in respect of a critical area of that process, namely, case reserves, complete.

558. Mr Salzedo also submitted that the Misconduct "*essentially took the form of a failure to understand sufficiently the full significance of the file review process, that carried over from one year to the next,"* and that accordingly the core nature of the Misconduct in the 2009 year could not "*fairly be regarded as separate from or independent of the Misconduct in the 2008 year*". In assessing the gravity of the Misconduct we do not believe that it should be compressed in that manner. At the beginning of the 2009 audit there was a clear opportunity to review all relevant matters, especially those relating to reserving, particularly given that in the light of market conditions it was recognised that the audit was likely to be challenging. That opportunity was not taken in respect of an important area. Furthermore, the series of "red lights" during 2009 also offered further opportunities for gaining better understanding of all relevant processes, including file reviews, and for taking appropriate steps to ensure that the audit dealt adequately with those processes.

c: Whether the Misconduct caused or risked the loss of significant sums of money

559. This matter has already been addressed at paragraphs 515-517 above.

d: Whether the failure to comply with professional standards was intentional or unintentional

f: Whether the Misconduct involved a failure to act or conduct business with integrity

g: Whether the Misconduct was dishonest, deliberate or reckless

560. It is convenient to consider these factors together.

561. Executive Counsel did not allege that the Misconduct of any KPMG Respondent was carried out dishonestly, deliberately or intentionally. For that reason the Misconduct cannot be placed at the very top of the scale of gravity.

562. However, Executive Counsel submits, relying on our findings, that Mr Hulse committed Misconduct "recklessly", contending that on 2 March 2010 he well knew that there was a real risk that the amount of reserves to be stated in the 2009 financial accounts was not soundly based, but he proceeded nonetheless in effect to approve the amount that would appear in the Syndicate's accounts. Ms Sabben-Clare QC, on behalf of Executive Counsel, sought to buttress this submission by referring to our observations regarding the embarrassing position in which Mr Hulse found himself in March 2010, having already signed off [...]'s half-yearly financial results (see paragraph 492 of the first part of the Draft Decision).

563. We have carefully considered our finding on this important issue, including reviewing a part of Mr Hulse's cross-examination to which Ms Sabben-Clare QC drew our specific attention. We clearly found that at 2 March 2010 the audit evidence was inadequate by reason of the failure properly to audit file reviews. However, Mr Hulse was still relying, albeit mistakenly, on the actuarial work performed both by [...] and by the KPMG actuaries who, subject to particular points, were satisfied that [...]'s calculations of reserves were not unreasonable. As we said, he reverted to the mantra that at the end of the day the audit was a "*reliance audit*".

564. We did, however, form the clear view, in the light of the evidence as a whole, that Mr Hulse would have been most reluctant, given all the "red lights" that had flashed, to approve the final figures, if he had not sought and obtained the relevant representations from Mr Morgan in relation to the consistency of reserving in the Syndicate. We concluded that that was an unjustified and mistaken course, for the reasons explained.

565. However, we did not conclude from the foregoing that Mr Hulse acted recklessly in the relevant sense. He believed in good faith, but in error, that he had sufficient evidence to justify his approval of the final figures. He did not proceed on the basis that there was a real risk that he was wrong, deciding nonetheless to press on. His difficult position vis-a-vis [...] might have to some extent compromised his objectivity and scepticism, but it did not cause him to act recklessly.

566. Mr Hulse has had a very distinguished career and he has not before been subject to any disciplinary proceedings. In a short oral address to us he stressed that he had always sought to take decisions, sometimes difficult ones, fairly and carefully, and not to risk bringing himself or his profession into disrepute. We have no doubt that that is the case. It should be made clear that nothing in this Decision impugns his honesty or good faith or suggests that he acted recklessly. Ms Sabben-Clare QC, who throughout these proceedings has presented Executive Counsel's case not only expertly but with scrupulous fairness, seemed to us on this one occasion to have been somewhat over zealous in making her submission.

e: The nature, extent and importance of the standards breached

567. KPMG, Mr Taylor and Mr Hulse failed to carry out their central task as auditors, namely, to obtain sufficient audit evidence in relation to reserving, which they had identified as giving rise to the greatest risk of misstatement, to enable them to express a professional audit opinion in relation to the Syndicate's financial statements.

568. There was also a serious failure to exercise professional scepticism, which is central to the role of an auditor. In particular, in relation to the 2009 audit, a number of "red lights" appeared, but no adequate steps were taken to address key issues that were highlighted. The importance of the standards arises from the importance of the audit function which, among other things, acts as a vital independent check upon management who may have reason to overstate profits and to understate liabilities.

h: and i: Whether any KPMG Respondent has been convicted of a related criminal offence

569. That is not the case.

i: The extent to which any potential financial crime (such as fraud) was facilitated

570. That is not suggested in this case.

m: Whether steps had been taken to address any similar Misconduct previously identified

571. That is not a relevant factor in this case.

n: Whether the Misconduct adversely affected or potentially adversely affected a significant number of people in the UK

572. This factor has already been considered in relation to Mr Morgan (see paragraphs 521-522 above). Mr Salzedo QC, on behalf of the KPMG Respondents, appeared to suggest that this was not a relevant factor. If *quod non* it could be demonstrated that the reserves for 2008 and 2009 were materially underprovided, and in consequence profits were overstated or losses understated, as the case might be, the effect would be minimal. We were told that the Names on the Syndicate were a closed group, and the composition of the Names did not vary significantly from year to year. If the reserves for 2008, for example, were underprovided, the Names for 2008 would pay to the succeeding Names a lower reinsurance to close than would properly have been due, but this was a matter of indifference if the Names were the same persons.

573. However, it appears to us that it is a matter of considerable importance that, for any Lloyd's syndicate, the accounts, whether for financial or underwriting year, should be accurately stated. The Names for any particular year expect, and are entitled, to know what is the true financial position of the syndicate in which they are participating. If,

for example, on a true and fair view, the syndicate made a loss, or was under performing, the Names would be entitled to demand both explanation and assurance that appropriate remedial or mitigating steps were being put in place by the management of the syndicate. That would be the case even if composition of the Names from year to year was unchanged. Names also would wish to take properly informed decisions as to whether to join or to remain with a particular syndicate in the light of its actual financial performance, accurately stated from year to year.

574. All the evidence that we have seen in this case strongly supports the proposition that everyone, whether the management of ESML, [...] or KPMG, was indeed agreed on the importance of ensuring that from year to year the financial statements should completely and accurately record the state of affairs of the Syndicate. It seems to us that no less would be demanded by Lloyd's itself, a fact evidenced, among other things, by the importance assigned to the role of the Syndicate Actuary.

575. In this context it is also important to bear in mind the position of [...] and its investors (see paragraph 522 above).

o: Whether the member/firm has failed to comply with any previous direction or sanction relevant to this Misconduct

576. That is not the case.

p: Whether it is likely that the same type of Misconduct will recur

577. Mr [...], a partner of KPMG LLP and Head of Quality & Risk Management for KPMG LLP and KPMG Audit Plc, made a witness statement dated 18 September 2018 for the purpose of these proceedings, in which, among other matters, he set out in some detail the steps that KPMG had taken to improve the quality and effectiveness of insurance audits.

578. In summary, during the planning stage documentation requirements have increased and there is now a standard form of instructions to audit actuaries, requiring the actuaries to undertake a detailed assessment process. Standardised work papers have also been developed and all working papers and supporting analysis must now be included in the audit file. In relation to motor insurance, since 2011 KPMG has used its in-house reserving software to support the audit of technical reserves to assist in identifying changes to development patterns. KPMG has also improved training and "knowledge sharing" within its insurance teams, including by way of weekly phone conferences.

579. Mr [...] stated that these steps have brought about substantial improvements. The FRC's June 2018 report of its Audit Quality Inspection identified KPMG's audit of insurance contract liabilities as an area of good audit practice. Mr [...] also explained the further significant initiatives that have been undertaken in order to improve the quality of its overall audit practice.

580. However, the general finding in the AQR June 2018 report was critical:

> *"The overall quality of the audits inspected in the year, and indeed the decline in quality over the past five years, is unacceptable and reflects badly on the action taken by the previous leadership, not just on the performance of front line teams. Our key concern is the extent of challenge of management and exercise of professional scepticism by audit teams, both being critical attributes of an effective audit, and more generally the inconsistent execution of audits within the firm."*

The "*extent and rigour of audit teams' challenge of management and whether they were sufficiently sceptical*" was also highlighted in the "Key Findings in the current year requiring action". That aspect was of course an important element in our own analysis of KPMG's Misconduct in the present case.

581. In the light of this material, we accept that KPMG has taken, and continues to take, steps to improve audit performance, particularly in the insurance sector. These steps reduce, but do not yet entirely eliminate, the risk of recurrence of the kind of Misconduct found in this case.

k: Whether the Misconduct could undermine confidence in the standards of conduct in general of Members and Member Firms and/or in financial reporting and/or corporate governance in the United Kingdom and/or in the profession generally

582. Without setting out again the nature and gravity of the Misconduct, it does appear to us that the relevant failure of the KPMG Respondents to obtain sufficient audit evidence and to apply adequate professional scepticism would be likely to reduce significantly the confidence of a well informed public in the standards of conduct in general of Members and Member Firms, and in financial reporting, in particular, of insurance enterprises, in the United Kingdom. KPMG is a major accountancy firm, and both Mr Taylor and Mr Hulse were partners in the firm. A well informed public would not reasonably have expected the KPMG Respondents to have fallen so far short in carrying out two audits of a substantial insurance enterprise in the respects set out in this Decision. The fact that they did so would be likely to shake the confidence of the public in relevant respects. It appears to us that KPMG itself has recognised that this might well be the case, for it has plainly taken a series of measures, described by Mr [...], to seek to ensure that the same kind of Misconduct should not recur. We assume that those steps have been taken, not only in part to assure the public of KPMG's competence and professionalism, but also more generally to promote the public interest by buttressing the public's confidence in the relevant respects.

s: In the case of a Member Firm, the effectiveness of its relevant procedures, systems or internal controls and/or implementation of ISQC 1 or equivalent

583. The audit documentation was "*very poor cut-and-paste*" in nature (see paragraph 368 above). KPMG failed to ensure that it obtained any real understanding of the file review process or to ensure that the Syndicate properly documented the process. It was a matter of central importance to the audit that the file review process was properly understood and audited. This was a straightforward task.

584. When [...] raised concerns on 2 March 2010, there was no proper written analysis of those concerns or how they should be addressed (see paragraph 402 above). There was informality in the final hours and no written memorandum from the KPMG actuaries or any written note to demonstrate how the issues raised had been resolved (see paragraph 406). The KPMG actuarial sign-off, when it did appear on 30 March 2010, was wholly inadequate (see paragraph 408).

585. The Tribunal recognises that the failure was limited to one aspect of the audit. However, for the reasons already given, that was a very important part of the overall audit.

t: In the case of a Member Firm, where the Member Firm's senior management became aware of the Misconduct and what action was taken at that point

586. We accept that in the circumstances of this case the fact that KPMG sought to rebut, with the support of expert evidence, Allegations that have in the event been proved by Executive Counsel should not serve to increase the seriousness of the Misconduct. We have already noted the steps that have been taken since 2010 to strengthen KPMG's audit procedures (see paragraphs 577-579 above).

v: Whether the Member held a senior position and/or supervisory responsibilities

587. Mr Taylor held a senior position and had supervisory responsibilities. He was the Responsible Individual ("RI") for the audits in both 2008 and 2009.

588. Mr Hulse was considerably senior to Mr Taylor and had far more accountancy experience: see paragraph 486 above. For the 2009 audit Mr Taylor in effect delegated the role of RI in relation to reserving matters (see paragraphs 486-487).

589. This is not a case where the Misconduct can be attributed to relatively junior and inexperienced members of staff, nor did KPMG at any time seek to present the case in that manner.

w: Whether the Member was solely responsible for the Misconduct

590. Mr Morgan, as Finance Director of ESML, has been found by the Tribunal to have committed serious Misconduct, for which a sanction of exclusion for two years has been imposed. Mr Rakow, the external actuary, has admitted Misconduct, for which he received a Severe Reprimand and a significant Fine.

591. Both Mr Taylor and Mr Hulse can fairly say that if Mr Morgan had fulfilled his duty to act competently and diligently, no Misconduct on their part would have occurred. Similarly, if Mr Rakow had performed his task competently, it is far less likely that Mr Taylor and Mr Hulse would have faced the serious Allegations made, and proved, against them.

592. It is unrealistic in this case to ignore entirely the Misconduct of Mr Morgan and Mr Rakow, and we recognise that their Misconduct to an extent reduces the gravity of the Misconduct of the KPMG Respondents. However, we believe that the degree of reduction is very limited. Whatever the shortcomings of Mr Morgan and Mr Rakow, the KPMG Respondents simply did not address adequately, and with requisite scepticism, the incidence and effect of file reviews, and did not ensure proper documentation, as explained at length in the first draft Decision, where their obligations in relation to the audit of the Syndicate's reserves plainly required them to do so. This was a fundamental failure. We are satisfied that if the KPMG Respondents had themselves acted competently and with due scepticism, the fundamental failure that we have identified would not have occurred.

CONCLUSIONS: KPMG, Mr Taylor and Mr Hulse

A. KPMG

593. KPMG accepted that a Reprimand was appropriate in this case, but contended that a Severe Reprimand was not justified.

594. Pursuant to paragraph 28 of the Sanctions Guidance:

> *"… a tribunal should consider <u>the seriousness of the Misconduct</u> to determine whether a Severe Reprimand is the more appropriate censure for the particular Misconduct* (emphasis added).

595. Some further assistance emerges from the Sanctions Report, at 8.13:

> *"A Severe Reprimand is obviously more serious than a Reprimand and is <u>appropriate</u> if there has been <u>seriously defective audit</u> or accountancy work or serious negligence. A Reprimand <u>is likely to be appropriate only</u> where the failings are not of any great seriousness and by a first-time offender"* (emphasis added).

596. We have already set out our reasons for concluding that the Misconduct was very serious indeed, towards the upper end of gravity in cases which lack the aggravating factors of dishonesty, intention or recklessness. We would not be promoting the objectives specified in the Sanctions Guidance if we did not impose a Severe Reprimand, and that is the sanction that we do impose.

597. As to the level of Fine, the Sanctions Report stated:

> *"… if one of the Big 4 firms was guilty of seriously bad incompetence, in respect of the audit of a major public company, where the errors were measured in nine figures or more and there had in consequence been either widespread actual loss or the risk thereof, a financial penalty of £10 million or more (before any discount) could be appropriate as being:*
>
> *(a) commensurate with the seriousness of the wrongdoing;*
> *(b) a meaningful deterrent; and*

> *(c) sufficient to meet the primary objective of sanctions."*
>
> *That assumes that the failings do not involve dishonesty or conscious wrongdoing. If they did, the figure could be well above that."*

598. KPMG is of course one of the "*Big 4 firms*". The audit was not, strictly speaking, of "*a major public company*". However, on any view ESML was a substantial insurance enterprise, and the Syndicate was a significant Lloyd's Syndicate, and had enjoyed a long history of profitability in the motor insurance sector. Furthermore [...], which had a major stake in the Syndicate, was a public company, listed on the […] Exchange, with multiple shareholders. We have no doubt that the relevant audits in this case fell within the broad category of audit which the Sanctions Report had in contemplation.

599. As to the quantification of the errors, and an assessment of actual or potential loss, we refer to our discussion at paragraphs 515-517 above. It is known how much in monetary terms was removed from case reserves in 2008 and 2009, amounts well above "*nine figures*". It cannot be stated with certainty to what extent the case reserves were thereby misstated, or the extent to which the final figure for reserves in the accounts for 2008 and 2009, was underprovided. Of course, the absence of comprehensive and appropriate contemporary documents regarding file reviews, which forms part of the Misconduct, would tend to impede any such a calculation. However, the amounts were very substantial, and, in our view, at least the risk of serious material misstatement and underprovision was present. For the same reasons, any actual financial detriment to Names on the Syndicate, or to [...] and its shareholders, is not susceptible to quantification. However, the real risk of serious financial detriment was present.

600. Mr Salzedo QC, on behalf of KPMG, submitted that a Fine of no more than £4 million was justified. Ms Sabben-Clare QC, on behalf of Executive Counsel, submitted that a Fine of £7 million was appropriate.

601. In our view, for reasons already stated, the gravity of the relevant Misconduct was towards the upper end of the scale of seriousness, for cases not involving dishonesty, intention or recklessness. To that extent, we would accept Ms Sabben-Clare's submission, and would agree that a fine of £7 million would not in principle be outside the range of appropriate penalties. However, it appears to us that Executive Counsel may have been influenced by a perception that Mr Hulse's Misconduct involved an element of recklessness. We rejected that interpretation. For that reason, and also on account of the uncertainties in this case regarding the extent of misstatement and of detriment, and taking account of the mitigating factors mentioned earlier, particularly the contributory Misconduct of Mr Rakow, we conclude that a somewhat lower Fine of £6 million is justified and necessary to promote the relevant objectives set out in the Sanctions Guidance.

602. As to financial resources and ability to pay, we note that in the year ended 30 September 2017 KPMG had total revenues in the UK of £2,029 million, including £548 million revenue from audit work and £221 million revenue from non-audit work undertaken for audit clients. Total group profits before taxation and members' profit share was £301 million. We are satisfied that KPMG has the resources to pay the fine of £6 million that we are imposing.

603. In determining the level of fine we have considered the previous cases to which the parties drew our attention. For reasons already explained, we have not found other cases particularly helpful. Mr Salzedo QC relied, to support his submission, on the case of *Quindell*. However, on the basis of the information before us, we are not convinced that that case is comparable, or that it would throw any doubt upon the appropriateness of the fine on KPMG that we are imposing.

Aggravating/Mitigating Factors

604. Relevant factors that might aggravate or mitigate the Misconduct have in essence already been taken into account in our primary analysis. It should, however, be recorded that KPMG does not have an unblemished disciplinary record. KPMG had been sanctioned on five previous occasions. However, only one case (*Quindell*) related to an audit, and that case arose well after the events giving rise to the present proceedings. In the circumstances we make no adjustment of the Fine by reason of this factor.

605. By way of further Sanction, KPMG agreed to accept a condition, in the following terms:

All audit engagements of insurance undertakings (defined as insurance undertakings to which Solvency II applies and Lloyd's syndicates) subject to the second line of defence ("2LoD") review at the 2018 year-end will be subject to an additional internal review with the following scope:

- to review the work performed by the KPMG internal actuarial team and evaluate whether it constitutes sufficient appropriate audit evidence on which the Responsible Individual (RI) may rely for the purposes of the audit at the relevant accounting reference date;
- to consider whether sufficient procedures have been undertaken to confirm the completeness and accuracy of the audit client's data used in the actuarial valuation and whether the methodology and assumptions used in the actuarial valuation were appropriate;
- to notify the 2LoD team and the RI of any potentially significant matters arising in the audit under review.

The internal review will be led by an insurance audit partner and will be completed by 30 June 2019. The report will be addressed to the KPMG Head of Audit Quality and a copy will be provided to the FRC within 28 days of its completion.

606. The Tribunal approved the foregoing condition.

B. MR TAYLOR

607. Mr Taylor was the RI for both the 2008 and 2009 audits. Without repeating our findings of Misconduct in detail, we concluded that Mr Taylor had failed to obtain any real understanding of file reviews, either at the planning stage of the audits or during the course of the audits, notwithstanding the significance of file reviews for the

setting of ultimate amounts of the Syndicate's Reserves. Many opportunities presented themselves for Mr Taylor to appreciate the importance of planning and conduct of the audit so as to take proper account of this matter, particular during the 2009 audit, but he did not respond appropriately or act with sufficient professional scepticism.

608. The nature and gravity of the Misconduct, having regard to the importance of the standards breached and potential effect of the Misconduct, justify only a Severe Reprimand. Even allowing for the contributing Misconduct of others, in particular Mr Morgan and Mr Rakow, we believe that the seriousness of the Misconduct can only be properly marked by a Severe Reprimand, in order to promote the objectives set out in the Sanctions Guidance.

609. In Mr Taylor's case, we also believe that a Fine is justified, to reflect the nature and gravity of the Misconduct, and to promote the relevant objectives. A Fine of £100,000 will be imposed. KPMG has confirmed that it will indemnify Mr Taylor against any Fine imposed on him. In any event Mr Taylor earns a substantial salary and is likely to do so in the future.

610. It has been agreed that it is also appropriate to impose a Condition on Mr Taylor, in the following terms, which we have approved:

For each audit where Mr Taylor is the Responsible Individual ("RI"), the planning and execution of the audit will be subject to review by an engagement quality control reviewer ("EQCR"). Where Mr Taylor is the RI for a group of companies the EQCR review shall be conducted on the audit of the highest level of consolidated financial statements for which Mr Taylor is the RI. This condition shall apply to audits of financial statements with a reporting period ending on or before 31 December 2020.

C. MR HULSE

611. We have already dealt with the submission of Executive Counsel that Mr Hulse's Misconduct was "reckless". It is submitted on his behalf that, in the absence of a finding of recklessness, dishonesty or intentional wrongdoing, a Reprimand would, in all the circumstances, be a sufficient Sanction.

612. We do not agree. We recognise that, unlike Mr Taylor, Mr Hulse's Misconduct related to one audit year, 2009. We also recognise, for the reasons explained in the first part of the Draft Decision, that the audit for 2009 was particularly challenging, and was at the time perceived to be challenging. However, Mr Hulse was specifically brought into the audit team on account of his very considerable audit experience and, as we have found, he did effectively take charge of the highly sensitive area of reserves. In our view, using his experience and expertise, he did come to appreciate that there were real issues of concern in respect of the Syndicate's reserves, and, in particular, did identify that one major area of concern was the incidence and effect of file reviews. This Decision chronicles the series of "red lights" that confronted Mr Hulse, and in his evidence to us he did earn credit by not seeking to deny or to underplay the existence and significance of these warning lights.

613. Nonetheless at the end of the day, in the face of these striking warning signs, he failed to take appropriate action and to exercise the degree of professional scepticism that was called for and which, we have no reason to doubt, had hitherto characterised his long and distinguished career as an accountant. In our judgment, he did fall back on the fatal mantra that it was a "*reliance audit*", and that it was not necessary for him to pursue further the real concerns that had arisen in respect of file reviews and the reliability of case reserves. At that point, he did, in our view, seek additional assurance by obtaining representations from Mr Morgan, a recourse that we concluded was both deficient and insufficient.

614. In these circumstances we are not able to mark the nature and gravity of the Misconduct, and to safeguard the objectives of the Sanctions Guidance, by imposing a simple Reprimand. Only a Severe Reprimand is justified. In an admirably succinct and focussed address to us, Mr Hulse explained both how in his career he had sought, sometimes in difficult circumstances, to maintain the highest professional standards and how the present proceedings had already resulted in significant detriment and his having to give up important positions that he had held. It is unfortunate that he has been placed in the present position towards the end of an unblemished and distinguished career, but for the reasons given, the imposition of a Severe Reprimand in this case is unavoidable.

615. We believe that a Fine is also justified in his case, and that in all the circumstances a Fine of £100,000 should be imposed. This marks the very serious Misconduct in respect of the 2009 audit, and adequately promotes the objectives of the Sanctions Guidance. KPMG will indemnify Mr Hulse in respect of any Fine, and in any event we are satisfied from the evidence that he has sufficient means to pay the Fine that we are imposing.

616. Mr Hulse is now retired from practice and Executive Counsel accepts that any Condition in respect of practice as an accountant would serve no useful purpose. We agree. His current roles as a director are regulated by the FCA, and the findings of the Tribunal will be notified to the FCA.

COSTS

617. The parties were able to agree an order for costs, which the Tribunal has approved. The parties were also able to agree an order for an appropriate part of the costs of the Financial Reporting Council incurred in these proceedings, which the Tribunal again approved.

618. Finally, it is necessary to state that the Tribunal reached unanimous agreement on the conclusions, findings, and orders. The Tribunal would also like to record its gratitude to all counsel, and to those supporting them, for the exemplary skill and efficiency with which they conducted these proceedings, and which considerably facilitated the task of the Tribunal.

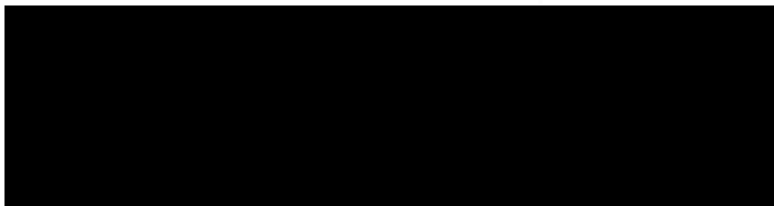
Sir Kenneth Parker

Ms Fiona Daley

Mr Mike Kipling

Mr Stuart Hill

Mr Colin Wilby



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