

THE EQUITABLE LIFE ASSURANCE SOCIETY

THE ALTERNATIVE PENROSE REPORT

Prepared for

Equitable Members' Action Group

By

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Equitable Life – The Alternative Penrose Report

INTRODUCTION

Our instructions from Equitable Members' Action Group were to examine the Equitable Life Assurance Society's published records and the many reports that have now been prepared covering different aspects of the Society's difficulties and prepare a comprehensive (but reasonably compact) report on what went wrong.

The Reports used for this purpose include

'Report of the Financial Services Authority on the Review of the Regulation of the Equitable Life Assurance Society from 1 January 1999 to 8 December 2000' - Ronnie Baird

'The Prudential Regulation of Equitable Life' – The Parliamentary Ombudsman

'Reserving for Annuity Guarantees' - M J Bolton and others

'Reserving, Pricing and Hedging for Policies with Guaranteed Annuity Options' - A.D. Wilkie, H.R. Waters and S. Yang

'An Assessment of the Adequacy and Objectivity of the Information Provided by the Board of the Equitable Life Assurance Society in Connection with the Compromise Scheme Proposal of 6 December 2001' – Prof. D Blake

'An Evaluation of the Financial Position of Equitable Life' - Cazalet Consulting

'The Equitable Life Assurance Society – The With Profit Fund 1993-2000' - Burgess Hodgson

This Report has been prepared by Colin Slater, partner in Burgess Hodgson Chartered Accountants for more than 30 years, (until 2002) a long-standing with profit policyholder in Equitable Life and EMAG committee member.

STRUCTURE OF THE REPORT

The main section of the report '**History and Topics**' covers a list of relevant subjects, as far as possible in chronological order.

- Equitable Life's Business
- With Profit Contracts and Bonuses
- The Regulatory Framework
- The Guaranteed Annuity Option
- Providing for the Guaranteed Annuity Option
- With Profits Without Mystery
- Personal Pension Plans
- Investment conditions in the 1990s
- Conventional Annuities and Alternatives
- Expansion
- The Differential Terminal Bonus Policy
- Excessive Bonuses
- The Report of the Annuity Guarantees Working Party
- The two GAR arguments
- Regulatory Action/Financial Engineering
- The Re-insurance Contract
- The Court Case
- The Abortive Sale Process
- Subsequent Events

There then follows a review of '**Errors & Omissions**' identifying what went wrong and what opportunities were missed. Finally the '**Conclusions**' section highlights the main reasons for the Society's downfall. The Appendix contains a chronological list of events (mostly extracted from the Parliamentary Ombudsman's report).

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EQUITABLE LIFE'S BUSINESS

Equitable Life Assurance Society ("Equitable Life") is the world's oldest mutual life assurance society, established in 1762. It is registered at Companies House as a guarantee company. As a mutual insurance company, it has no shareholders. Its voting members are its with-profit policyholders.

Traditionally it specialised in pension policies, particularly for self-employed professionals (lawyers, doctors, accountants etc.) It also provided group pensions for employees and additional schemes for those with public service pensions, including civil servants and judges. Its distinguishing features were its impressive investment and bonus record and its low charges, partly derived from the fact that it did not pay commissions to introducers. These factors made it increasingly popular with the rise in consumerism during the 1980s and 1990s. Its low charges are believed to have made it the model for low-cost Stakeholder products.

Although it provided conventional (non-profit) annuities and unit linked products, the bulk of its business was with-profit, of which almost all was pension-based. The with-profit pension side includes self-employed deferred annuities (based upon the tax rules of the 1950s), personal pension plans (based on the tax rules of the 1980s), with-profit annuities and pension drawdown schemes. The two last mentioned are products, which Equitable pioneered.

Equitable was not involved in general insurance (e.g. marine, motor, fire or accident).

WITH PROFIT CONTRACTS AND BONUSES

Originally insurance contracts were 'non-profit'. The policyholder paid a premium and the insurance company covered him for a specific risk, paying a predetermined sum if that risk materialised. If premiums received exceeded claims paid, the insurance company retained the profit. They were 'non-profit' as far as the policyholder was concerned, who only received any payment if the insured risk matured, for example if his house burned down. The non-profit principle still applies to most risk-based contracts. These include motor, fire and short term life policies. However some insurance contracts are very long term and are essentially 'investment-based'. These include, pension, endowment and whole of life policies. For these the 'with-profit' contract was devised. Under this arrangement the Insurance Company shares with the policyholder part or all of the profit it makes from investing long-term premium receipts and providing non-profit contracts.

With-profit contracts allow the company to add bonuses to the original sum assured as profits are earned. Traditionally these were 'reversionary', which meant that once added, they became part of the policyholder's contractual entitlement and could not be taken away.

This worked well whilst investment was predominantly in government debts ('gilts'), but the onset of rampant inflation in the 1960s and 1970s encouraged significant investment in company shares quoted on the stock market ('equities'). Insurance companies made substantial gains on the value of premiums invested in equities and needed to pass on these gains to policyholders to maintain or enhance their competitive position. However if they declared these profits as reversionary bonuses and the stock market subsequently fell, they might not be able to pay the contractual amount when the policy matured. Instead they created a new form of bonus which was voted in addition to the reversionary bonus, but did not form part of the contract, could be taken away if necessary and only became payable upon maturity. The industry called these 'terminal' bonuses. Equitable introduced them in 1975 and called them 'final' bonuses.

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THE REGULATORY FRAMEWORK

The provision of life insurance and pensions is a regulated industry. This regulation was divided into two sections:

	Prudential	Conduct of Business
Relating to	The financial stability of insurance companies	The way their products are marketed and sold
Legislation	Insurance Companies Act 1982	Financial Services Act 1986

The Baird Report described prudential regulation as follows:

‘2.2.2 In regulating authorised insurance companies, the main objective is to protect policyholders against the risk of companies being unable to pay valid claims. In the case of life insurance companies, this includes the risk that they will be unable to meet policyholders’ reasonable expectations (“PRE”). ‘

The Insurance Companies Act and supporting regulations require companies to submit annual ‘Returns’ showing how their assets exceed their contractual liabilities to policyholders by a sufficient margin. These are in addition to annual Financial Accounts and very much longer (several hundred pages). Neither these Returns nor Financial Accounts are concerned with terminal bonuses, which are not contractual. The intention of regulatory Returns is to demonstrate technical ‘solvency’. This is a sophisticated concept involving liabilities, which mature over a long period into the future and is really only understood by actuaries.

The concept of policyholders’ reasonable expectations is more difficult to define. An actuarial profession working party reported in 1993:

‘For with-profits business, PRE will be focused on the total benefit [including terminal bonuses] payable in the event of a claim. Policyholders are entitled to expect that benefits will reflect the accumulated value of premiums paid less expenses and the cost of risk benefits, in accordance with the actual experience of the office. In actuarial terminology, asset shares should provide the starting point for determining maturity benefits.

The degree to which returns are smoothed over time, and the extent to which part of the asset share is retained to finance future expansion, will vary considerably between offices. ‘

Equitable Life was unique in the with-profit industry in providing annual valuations to policyholders which showed the value of their policies at the previous 31st December including terminal bonuses. These were expressed to represent the policyholder’s ‘smoothed asset share’. There is a strong argument that these statements created a ‘policyholders’ reasonable expectation’ that when terminal bonuses were voted there were sufficient assets to cover aggregate policy values.

During the relevant period the parties responsible for regulation were

	Prudential	Conduct of Business
From early 1980s to 1997	Regulator – Department of Trade and Industry	Regulator – Personal Investment Authority (since 1994)
1998	Regulator – HM Treasury	Regulator – Personal Investment Authority
1999-late 2001	Regulator – HM Treasury (but role contracted out to Financial Services Authority)	Regulator – Personal Investment Authority (but role contracted out to Financial Services Authority)

In late 2001 the Financial Services Authority (‘FSA’) took over both roles.

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Another key part of the regulatory framework is the Government Actuary's Department ('GAD'). Its role was described by the Baird report:

'2.8.3 Since 1984, GAD has operated a major part of life insurance supervision, as a delegated responsibility, under the terms of a service level agreement originally with the Department of Trade and Industry (DTI), subsequently with HM Treasury (HMT) and now with the FSA, as the prudential regulators (the "GAD SLA"). The GAD SLA sets out the detailed services to be provided by GAD. In particular, GAD has the main role in the scrutiny of the regulatory returns and in providing advice to [the prudential regulator] on what action needs to be taken in following up points arising from the scrutiny.'

2.8.4 The product of GAD's examination of the regulatory returns is a "scrutiny report" which forms a key element of the regulatory process of the FSA. Both the regulatory returns and GAD's scrutiny reports are considered in further detail below.

2.8.5 In addition to the scrutiny report (and authorisation processes), GAD also provides advice on areas which impact on a life insurance company's solvency or Policyholders' Reasonable Expectations ('PRE').

THE GUARANTEED ANNUITY OPTION

From 1956, many insurance companies issued pension policies to the self-employed and others, to take advantage of the tax relief that then became available. These were typically constructed as 'deferred annuities'. The policyholder paid a premium while he was working, which bought him a pension (a lifetime annuity), the payment of which was deferred until he retired.

The level of an annuity is governed by the interest rates that apply when that annuity starts to become payable. This is because the insurance company has to invest the money from which the annuity is to be paid into government debt or similar investments at that time. In order to quantify the deferred annuity at the time the policy contract was originally written the insurance company had to estimate the level of interest rates that would apply when that annuity became payable, possibly many years into the future. For example, when a 40-year-old took out a policy in 1975, the insurer had to estimate the level of interest and annuity rates, which might apply in 2000, when that policyholder reached 65.

In the early years of deferred annuities the interest rates assumed were of the order of 3% or 4%. As inflation raged during the 1970's, interest rates climbed dramatically. In 1975 Equitable Life increased the rate of interest assumed in its deferred annuity contracts to about 8%. This insured the policyholder against the risk that rates might fall below that rate by the time he started to draw his annuity. Contracts which cover this risk are called 'Guaranteed Annuity Rate' ('GAR') ones. Alternatively they may be called 'Guaranteed Annuity Option' ('GAO') ones, because the policyholder has the option of taking the annuity guaranteed in the contract if this is better than the annuity his fund might buy on the open market.

PROVIDING FOR THE GUARANTEED ANNUITY OPTION

In 1975 when interest rates were very high, this GAO risk must have looked trivial. No charge was made for taking on the risk and nothing was set aside or 'reserved' to provide for it. Equitable was not alone in issuing this type of policy or in making no provision for the risk it ran. However Equitable Life's risks were greater because:

- a) The bulk of its business was pension based and most of it included the GAO.
- b) Its policies were very flexible, allowing the policyholder to select his retirement date at any time between 60 and 75. Other insurers required the policyholder to select his 'normal retirement date' at the outset and guarantees only applied to this date. As regards any particular policy, they were only at risk if interest rates were below the critical rate on the policyholder's normal retirement date (e.g. his 65th birthday). Equitable Life was at risk for a period of up to 15 years, when the policyholder might choose to retire.

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- c) Its policies contained the right for the policyholder to pay additional premiums, even at a time when interest rates might have already fallen below the critical rate. (The policyholder's option would be described in technical parlance as 'in the money').
- d) Equitable had no surplus assets to call upon in time of need.
- e) Equitable had no shareholders to supply more capital

The issue may well have appeared academic in the 1970s, but from about 1983 onwards inflation and interest rates started to fall and the pattern was established by the late-1980s.

There is no easy way of valuing the liability for which an Insurer may be responsible in respect of option and guarantee risks. The simplistic approach has been only to value such liabilities if they would have a cost if they were exercisable against the company at the valuation date, that is if they are 'in the money'. In the case of the GAO, a comparison in 1982 (for example) of then current interest rates of about 14% with the critical GAO rate of 8% would have produced a valuation of nil. The same result would have been arrived at 2 years later when current rates had fallen to 10%. This simplistic approach fails to allow for the possibility that interest rates might fall below the GAO by the time some of the policies matured.

A more scientific ('stochastic') method of valuing such liabilities based upon statistics and probabilities had been developed in the 1970s and early 1980s. The Maturity Guarantees Working Party of the Institute of Actuaries and the Faculty of Actuaries recommended its use in 1980. A development, which was inspired by this work, was the "Wilkie model", a fuller stochastic asset model developed by Professor A. D. Wilkie and first presented to the Faculty of Actuaries in 1984. This has subsequently become one of the standard actuarial models of its type.

A provision made for GAO costs using the stochastic method in the 1980s might not have been large, but it would have alerted the Society to the risks it was running. It might also possibly have accelerated its withdrawal from this area, reduced its bonuses as interest rates fell further during the 1990s and made it better able to withstand the blows it suffered in the 2000s.

Be that as it may, Equitable Life made no provision (stochastic or otherwise) for the GAO risk until the regulators required it to do so in 1998. By that time interest rates had fallen to about 5%, were well below the critical 8% level and the liability was estimated by the directors at £1,600 million.

WITH PROFITS WITHOUT MYSTERY

'With profits without mystery' was the name of a paper presented by R. H. Ranson and C. P. Headdon (both of Equitable Life) to the Institute of Actuaries, 20 March 1989. It outlined Equitable Life's approach to with profits. In general, the authors saw themselves as running a 'managed fund', rather like a unit linked operation, where policy values are directly linked to the value of underlying assets. To this was added the with-profit concept of 'smoothing'. Instead of policy values fluctuating (sometimes wildly) with the value of the underlying assets, bonuses were declared annually out of profits to provide a more stable policy value, but one, which broadly reflected the long-term rate of growth of underlying assets.

Most Insurance Companies achieved 'smoothing' by use of an 'estate', that is a reservoir of assets in excess of amounts payable to current policyholders. This allowed them to ensure that policy values were 'covered' by assets in bad times, from surpluses established in good times.

The Equitable Life actuaries regarded the creation of an 'estate' as unnecessary. Instead they espoused the concept of the 'full and fair' distribution of profits. They saw the full distribution of profits as a means of maintaining fairness between generations of policyholders. (This was how it was presented to policyholders in marketing literature).

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Other speakers pointed out the benefits of having an estate as:

- a) providing capital for the development of the business
- b) allowing a more aggressive and potentially more profitable investment portfolio
- c) providing a cushion for bad times

The unasked and unanswered question was what happened to a company with no estate in the event of some unexpected misfortune, a sustained fall in investment values - or both?

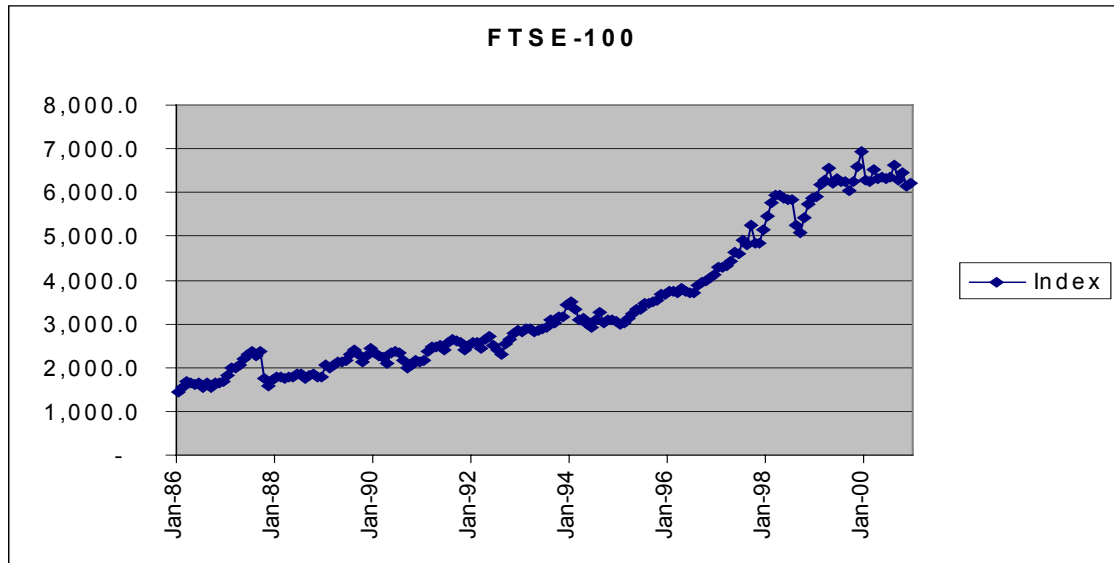
PERSONAL PENSION PLANS

The tax rules changed in the 1980s to encourage greater provision by individuals for their own retirement income. Such plans were not based upon deferred annuities. Instead the concept was that the individual could pay premiums into a fund with an insurance company. The proceeds of the fund at his retirement would be available to buy an annuity from the original company or from another one, at the choice of the policyholder at that time. There was no question of a guaranteed annuity rate.

Equitable ceased issuing the old Deferred Annuities (with the Guaranteed Annuity Rate) and started to issue the new Personal Pension Plans (without the Guaranteed Annuity Rate) in 1988. Both types of policies shared in profits in the same way. This was in spite of the fact that the former enjoyed a benefit (the 'GAO' or 'GAR') which the latter did not. Furthermore Equitable made no provision for the GAO risk, of which the ('non-GAR') Personal Pension Plan policyholders were unaware. As the number and value of new PPPs increased over the years, Equitable passed the GAO risk over to a new generation of unsuspecting policyholders.

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INVESTMENT CONDITIONS IN THE 1990s



As the chart shows, the value of company shares quoted on the stock market rose fairly steadily from the crash of October 1987 and then with increasing vigour during the latter half of the 1990s. One of the big factors creating this boom was the decline of interest rates, from about 10% in the late 1980s to about 4% a decade later. During the 1990s Equitable Life had about half of its portfolio invested in equities.



The above chart (extracted from the Baird report) shows interest rates for the period 1976-1998.

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CONVENTIONAL ANNUITIES AND ALTERNATIVES

One of the less pleasant side effects of falling interest rates was falling annuity rates. The cost of annuities increased as interest rates fell. This was because of the increasing cost of the 'gilts' (government debt) which back the provision of lifetime annuities.

In the case of conventional annuities, the Insurance Company guarantees a fixed annual payment for life, regardless of actual investment performance and thus takes on the investment risk. Companies cover this risk by investing the annuity premiums they receive into gilts, whose performance is predictable, if unexciting. The Insurance Company also takes on the risk that the policyholder might live longer than predicted by current mortality tables.

Various methods were developed to provide 'better value' annuities. Equitable Life pioneered the development of drawdown schemes and with-profit annuities.

Drawdown schemes are simple in concept. Instead of paying the pension fund the policyholder has accumulated over his working lifetime to an insurance company in exchange for a conventional annuity, the fund remains in existence. The policyholder simply draws his pension from the fund. The rules are designed to prevent him drawing his pension too quickly and at 75 he is required to buy a conventional annuity with an insurance company to ensure that he does not 'outlive his money'. In the meantime the fund can be invested in potentially more profitable investments than gilts. The advantages are that if investment values rise the policyholder can draw a bigger pension. Clearly the policyholder takes the investment risk. If investment values fall he may well have to reduce his pension. If he dies before reaching 75 the fund goes to his dependants. Such schemes are most suitable for those with substantial funds.

With-profit annuities are really just a series of single premium endowment policies, with one policy maturing each year of the policyholder's expected lifetime. As each annual policy matures its proceeds are used to pay that year's pension. The Insurance Company covers the risk of the policyholder 'outliving his money' from the policies left by those who 'die young'.

The amount invested in each year's endowment policy is calculated at the outset using an assumed growth rate. The usual method is that the endowment premiums are so calculated that the addition of annual growth at the assumed rate will produce a level pension. The premiums earmarked to pay the early years' pensions are larger than those required to pay the later ones.

The key point is that the investor takes the investment risk, not the Insurance Company. If bonus rates are good, his annual endowment proceeds are bigger than assumed and he gets a bigger annuity payment. If bonus rates are bad, he gets less. This is the significant difference between a with-profit and a conventional annuity.

Both drawdown and with-profit annuities were introduced after 1988 and are consequently non-GAR. Both were heavily marketed by Equitable during the 1990's.

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EXPANSION

Equitable Life's marketing was very successful indeed. Its accounts show its assets rising from £6,000 million in 1990 to £34,000 million in 2000. Some of the increase related to additional premiums into existing GAR policies, but the vast majority of new premiums were into the non-GAR Personal Pension Plans, Drawdown schemes and With Profit Annuities.

By 1999 the total value of the with-profit section was £27,000 million of which GAR policies amounted to £8,000 million.

THE DIFFERENTIAL TERMINAL BONUS POLICY

Falling interest rates meant that the critical 8% rate used in guaranteed annuity rate assumptions in post 1975 GAR policies was first breached in 1993. This put policies with the guaranteed annuity option 'in the money'.

The Equitable board then introduced a new terminal bonus policy to counteract this. As each GAR policy matured the policyholder was offered an annuity at current (low) rates based upon the full value of his fund including terminal bonuses. If he sought to exercise his option to take his guaranteed annuity, then his terminal bonuses were reduced. The guaranteed annuity he was then offered was based on the contractual value of his fund, excluding terminal bonuses. In crude terms, he could have either his terminal bonus or his annuity guarantee, but not both. Retiring policyholders disagreed, they thought they were entitled to the guaranteed rate applied to their whole fund, including terminal bonuses.

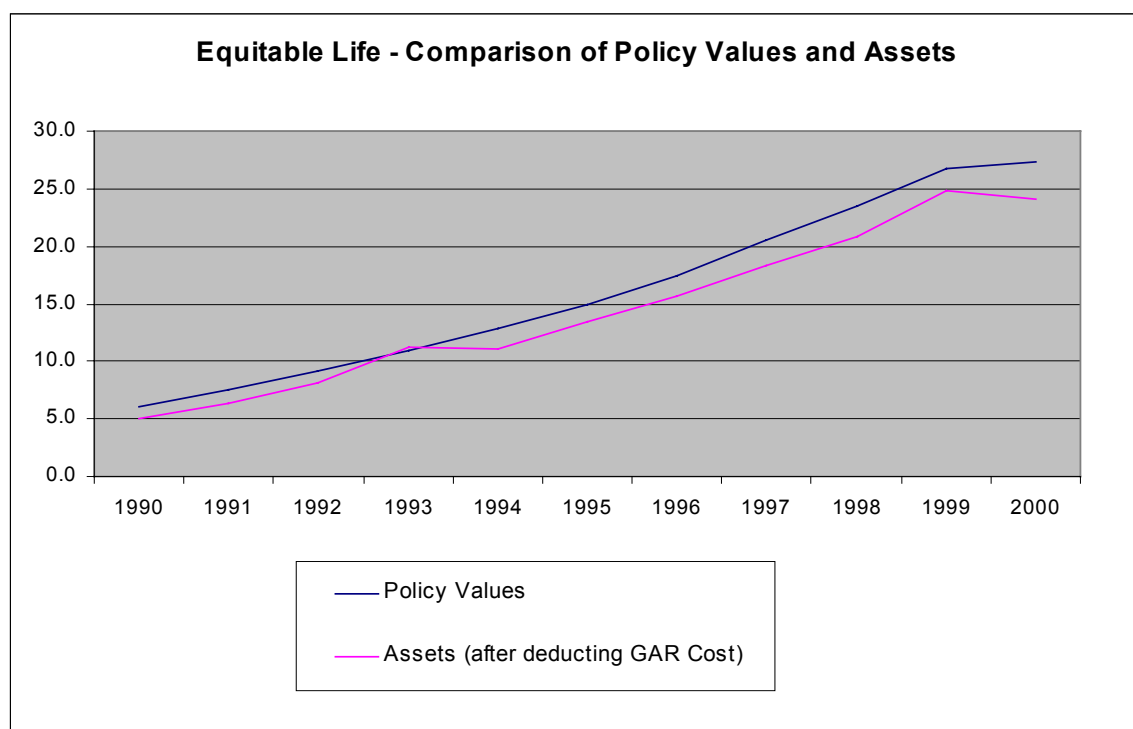
Initially the difference was not very material. The typical guaranteed annuity was also in a format that was unattractive to many policyholders. It was for a single life, at a fixed rate, payable annually in arrears and no part would be returned to the policyholder's estate if he died soon after taking it. The take-up rate of guaranteed annuities was understandably low. The matter ceased to be an issue when interest rates then rose.

This relief for Equitable turned out to be short lived. In 1996/97 interest rates fell sharply and the GAO achieved a substantial value if it applied to the full value of the policy including terminal bonuses and not just to the contractual value. Aggrieved GAR policyholders started complaining to the regulators.

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EXCESSIVE BONUSES

EMAG commissioned a detailed forensic analysis by ourselves of Equitable's financial accounts and actuarial regulatory returns (published March 2003). This revealed that Equitable's parlous state was brought about not only by the Society's exposure to GARs but also by a long-standing second flawed strategy, that of "over-bonusing", or overstating policy values, practised for more a decade. Equitable's own internal papers, revealed on May 25th, 2003 to the Court of Appeal by ex-auditors Ernst & Young, confirmed the validity of the report's findings.



From Equitable Life's actuaries' description of their operation of the with-profit fund contained in 'With Profits Without Mystery', one would have expected a much closer correlation between policy values (including terminal bonuses) and asset values. Policyholders were surprised to learn that there was a billion pound asset deficit, which went back a decade. In percentage terms the deficit was bigger in the early 1990s than it was in the late 1990s.

The effect of this 'over-bonusing' was that:

- a) about half of terminal bonuses was not represented by assets
- b) the 'past performance' record of Equitable Life policies was enhanced by profits, which had not been made
- c) new (and existing) policyholders were encouraged to invest based upon this 'past performance'
- d) excessive payments were made to leaving policyholders throughout the decade
- e) Equitable Life's finances were chronically weak
- f) There was nothing in the 'smoothing kitty' when the stock market fell in 2000-03. Indeed the smoothing kitty was 'overdrawn'.

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ACCOUNTS

EQUITABLE LIFE WITH PROFIT FUND

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn
(figures in bold were supplied by the Society other figures are our estimates based upon Accounts and Returns)											
Bonus Rate	12.0%	12.0%	10.0%	13.0%	10.0%	10.0%	10%	13%	10%	12%	3.3%
Policy Values											
At beginning of Year	5.05	6.06	7.62	9.21	10.97	12.94	14.96	17.42	20.60	23.52	26.82
Bonus	0.61	0.75	0.78	1.20	1.11	1.29	1.51	2.22	2.14	2.81	0.85
	5.66	6.81	8.40	10.41	12.08	14.23	16.47	19.64	22.74	26.33	27.68
Premiums Received	0.98	1.42	1.53	1.55	1.56	1.93	2.39	2.83	2.91	2.72	2.15
Claims Paid	(0.6)	(0.6)	(0.7)	(1.0)	(0.7)	(1.2)	(1.4)	(1.9)	(2.1)	(2.2)	(2.4)
Policy Value at Year End	6.06	7.62	9.21	10.97	12.94	14.96	17.42	20.60	23.52	26.82	27.44
Assets	5.04	6.36	8.12	11.17	11.11	13.37	15.70	19.24	22.37	26.14	26.00
Surplus (Deficit) (ex GAR cost)	(1.0)	(1.3)	(1.1)	0.20	(1.8)	(1.6)	(1.7)	(1.4)	(1.2)	(0.7)	(1.4)
Contractual GAR Cost (per Claim against Auditors) ***	0.00	0.00	0.00	0.00	0.00	0.00	0.00	(0.9)	(1.6)	(1.3)	(1.9)
Surplus (Deficit) (inc GAR cost)	(1.0)	(1.3)	(1.1)	0.20	(1.8)	(1.6)	(1.7)	(2.3)	(2.8)	(2.0)	(3.3)
Surplus (Deficiency)											
As a % of Policy (ex GAR Cost)	-17%	-17%	-12%	2%	-14%	-11%	-10%	-7%	-5%	-3%	-5%
As a % of Policy (inc GAR Cost)	-17%	-17%	-12%	2%	-14%	-11%	-10%	-11%	-12%	-7%	-12%

*** A provision using the stochastic method would have been higher and would have spread the cost further back

THE REPORT OF THE ANNUITY GUARANTEES WORKING PARTY

In January 1997 the Faculty and Institute of Actuaries set up a working party (M J Bolton and others) to review the Guaranteed Annuity Rate option issue and survey the reserving practices of life insurance companies. It reported in November of that year.

The report said ‘Historically many pension contracts issued by life companies contained options to convert the cash proceeds of the policy on retirement into annuities on terms guaranteed in advance. Such options were particularly common up to the mid-1980's and have progressively been withdrawn for new business by companies since then. Nevertheless, companies collectively have over £35bn of liabilities to which such guarantees apply. With relatively low interest rates and improving mortality, the guarantees are now potentially very valuable.’ It went on ‘Questionnaires were issued to 85 insurance companies or groups of companies writing pensions business. Responses were received from 66 companies, of which 41 have annuity guarantees and 25 do not.’

By late 1997 interest rates had fallen below that which triggered many of the guaranteed annuity options, which were therefore ‘in the money’. As policyholders retired, they could be expected to exercise their option to take the guaranteed annuity and so impose an immediate cost on insurance companies. If interest rates continued to fall the cost to those companies would increase.

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The report found no consistency between companies of either the contractual terms of their GAO policies or of the methods used to provide for them. The working party found that a significant group (including Equitable) made no provision at all.

It concluded ‘We have considered whether it is possible to recommend an approach to reserving. However, the variation between products and between the approaches of different companies to managing the guarantees is so great that we have felt unable to do so.’

The report described Equitable Life’s method of dealing with annuity guarantees as follows: ‘Review whether and to what extent the guarantee will be covered by terminal bonus adjustments. Providing that terminal bonus adjustments will be used and are sufficient to cover guarantees in all circumstances, there is an argument for not reserving for such guarantees - no explicit provision is made for terminal bonuses and hence the provision for guarantees is simply part of this implicit provision subject to the existence of appropriate terminal bonus margins.’

The working party found that the Equitable Life ‘approach could be viewed as being unsound because no explicit provision is made for an explicit guarantee.’

In layman’s terms:

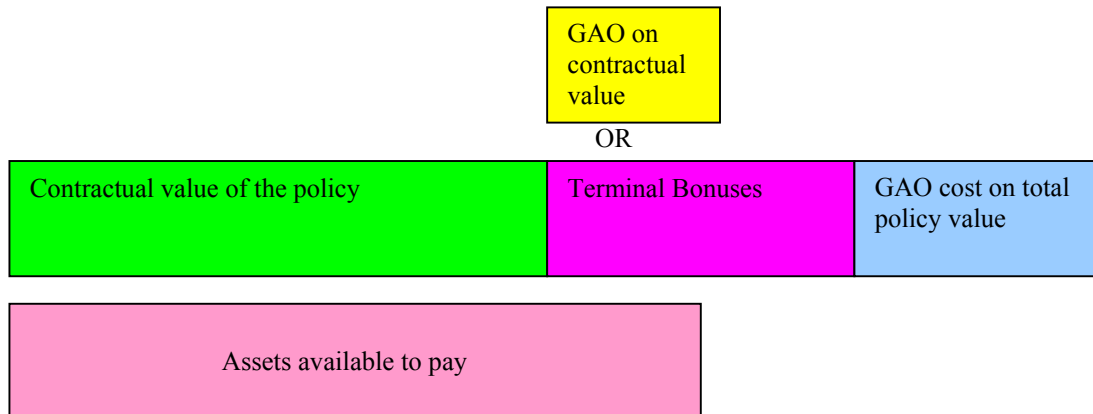
- a) Companies are required to ‘provide for’ (treat as a debt) all contractual liabilities in their Annual Returns to the regulator and in their Financial Accounts. No provision is required for terminal bonuses, which are non-contractual.
- b) Equitable had guaranteed to pay annuities on the contractual portion of their GAR policyholders funds, (excluding terminal bonuses) at a rate that could no longer be obtained in the market. This gave rise to an extra cost for the Society
- c) The Society made no provision for this extra cost in its Annual Returns to the regulator or in its Financial Accounts.
- d) The directors’ argument was that retiring policyholders were allowed to take either their terminal bonuses or their annuity guarantee, but not both. Usually the terminal bonuses were more advantageous and the take up of guaranteed annuities was very small. There was no need to provide for a cost, which did not materialise.
- e) The alternative argument was that the extra cost of the GAO was contractual as opposed to the terminal bonus, which was not. Effectively the existence of the GAO made part of the terminal bonus contractual and a provision should have been made.

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THE TWO GAR ARGUMENTS

For clarity it must be pointed out that the Society did not dispute it had a responsibility for the extra cost of guaranteed annuities arising from the contractual portion of policy values. The disagreement between the Society and the actuarial profession working party (and later the regulator) was about whether or not such costs had to be provided for in accounts and returns. The argument between the Society and its GAR policyholders (which subsequently went to Court) was about the application of the guarantee not only to the contractual portion of policy values but also to the terminal bonus portion.

The following diagram of the components of a typical GAR policy of the late 1990s indicates the areas of dispute.



The Society accepted that it had to provide for (treat as a debt in its returns and accounts) the contractual value of its policy (in Green). It disputed with the regulator that it had also to provide the GAO cost upon that contractual value (in Yellow)

The Society accepted that upon maturity it had to pay both the contractual value (in Green) and terminal bonuses (in Pink). These constituted what the Society saw as the full value applicable to that policy. It disputed with GAR policyholders that it should also pay the extra cost of the GAO upon that full value.

REGULATORY ACTION / FINANCIAL ENGINEERING

There is little evidence of any action by regulators prior to 1998. Indeed the evidence suggests there was only routine scrutiny of Equitable Life's annual regulatory returns. The Government Actuary's Department denied that they had been informed of the Society's treatment of guaranteed annuities in 1993.

The report of the actuarial profession working party in late 1997 seems to have come as a surprise to the regulators. If so, it must have been an unpleasant one, since it revealed that

- a) the issue of policies with guaranteed annuity options was widespread throughout the industry
- b) many such options were already 'in the money'
- c) there was no standard method for providing for such guarantees
- d) the actuarial profession was not able to recommend one
- e) some companies had made no provision at all
- f) the amounts involved were already large and would increase if interest rates continued to fall
- g) provisions which might have been made fairly painlessly over the previous 20+ years, would have to be made in a hurry just to 'catch up' with the risk that had already materialised

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The only redeeming feature was that the stock market was still going up.

In June 1998 the Government Actuary's Department ('GAD') initiated a survey of the approach of life companies to 'reserving' (providing) for guaranteed annuities.

A dialogue with Equitable Life over its treatment of guaranteed annuities commenced in September 1998 and continued through until February 1999. This is described in detail in the report of the Parliamentary Commissioner for Administration (The 'Ombudsman.'). It is reproduced in an Appendix available on EMAG's Web site and is worth reading in full since it demonstrates how regulation operated in practice. It reveals:

- a) how long it took for GAD to review Equitable Life's regulatory returns
- b) how many 'regulators' were involved (HM Treasury, FSA, GAD, PIA)
- c) how much time and effort was expended in liaison between them
- d) how there was a conflict of interest between 'prudential' and 'conduct of business' regulation and how in practice the former (protecting the insurance company, existing investors and the industry) took precedence over the latter (protecting incoming investors).
- e) how Equitable Life threatened judicial review in support of its views and achieved ministerial intervention by the Economic Secretary.
- f) that regulators had not previously investigated Equitable Life's exposure to GAR risks
- g) that the regulators did not raise the point that something like half the terminal bonus content of Equitable Life's policy values was not represented by assets.

The outcome was a compromise under which Equitable made a substantial provision (£1,593 million) in its regulatory returns (but not in its financial accounts), but the effect was virtually eliminated by a rather questionable re-insurance arrangement (valued at £809 million) and an allowance for 'future profits' of £850 million.

Equitable voted a reversionary bonus of 5% and an overall bonus (including terminal bonus) of 10% for 1998. These were down on the equivalent figures for the previous year (6.5% and 13% respectively), which may have been in part as a result of regulatory pressure. No doubt falling interest rates and some lack of stock market confidence also affected the decision.

THE RE-INSURANCE CONTRACT

The re-insurance contract referred to above was with Irish European Reinsurance Company Limited. This reinsurance contract seems to have been mostly for cosmetic effect. Its 'value' for Actuarial Return purposes was shown at more than £800 million, whereas the annual premiums were more like £800 thousand. A risk must either be very slim indeed or the cover inconsequential for an annual premium to be only one thousandths of the sum assured.

The Baird Report described this agreement thus ;

3.27.5 ...IERC agreed to pay for the additional costs of GAOs should they be exercised on more than 25% of the value of funds retiring in any one year. If this occurred, IERC would be liable to pay Equitable Life an amount which equalled the additional cost of providing an annuity at the GAR, over the cost of an annuity at current annuity rates. However, IERC would then have "call" on the surplus emerging after the date of the claim on the reinsurance.

3.27.6 The agreement also provided that IERC would recover, in instalments, any sums it had paid to Equitable Life. The size of the instalments was limited so that payment would not make Equitable Life insolvent.

3.27.7 GAD explained to us the purpose of the agreement:

"The purpose of the treaty was to enable Equitable Life to reserve on a basis which was more akin to their view as to what a prudent reserving basis should be, because they felt that it required quite a significant change in the practice of policyholders for the take-up rate to get anywhere near 25%, which was the level which they felt was prudent. They negotiated with the reinsurer that the reinsurer should take the commercial risk that the take-up rate might exceed 25%, which the reinsurer was happy to do

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because it wasn't under the control of the UK supervisory regime. If it was a UK-regulated reinsurer, we would require the reinsurer to set up the balance of the liability under the 75% that it was taking.”

3.27.8 The agreement was conditional on there being no change to Equitable Life's terminal bonus practice ‘

In short, Equitable Life was allowed to ‘re-insure’ or more accurately provide a loan facility for that part of the GAO risk it did not want to provide for on its regulatory returns. The re-insurance was nullified if the Society changed its bonus methods, as subsequently happened or if it became insolvent. The regulator knew that the risk was being taken on by an offshore company, which was not subject to its requirement for such risks to be fully provided against. This is known as ‘regulatory arbitrage’.

FSA statement on 26 November 2001 confirmed the questionable nature of this arrangement. No credit for this re-insurance appears in the Society's 2001 Returns.

‘The FSA is today setting out the background to the recent discovery of a previously undisclosed letter that raised questions about the true value of a reinsurance contract entered into by Equitable Life in early 1999. The reinsurance contract itself has subsequently been renegotiated. On 24 September 2001, Equitable Life provided the FSA with a copy of a “letter of understanding” dated 1 April 1999 from the then Appointed Actuary, Christopher Headdon, to the Irish European Reinsurance Company, which provided reinsurance to Equitable Life. The existence of this side letter to the reinsurer had not previously been disclosed to the FSA (nor, so far as we know, to Equitable Life's auditors) and its legal implications were not clear. The new management of the Society said that they themselves had only recently become aware of its existence. The FSA took the view that the contents of the letter raised questions about the true value of the reinsurance contract that Equitable Life had entered into in early 1999 and which was shown in its regulatory returns. The FSA concluded that, had it been aware of the letter at the earlier stage, it would not have been prepared to accept the reinsurance arrangements as providing as much security for reserving purposes as was in fact taken. The FSA will be making further enquiries about the circumstances in which this letter was written and the intentions of the parties concerned. ‘

THE COURT CASE

In December 1998 Equitable's Board resolved to initiate a test case in the courts to determine whether they had the right to declare differential terminal bonuses. This arose from their dispute with GAR policyholders as to whether or not the guaranteed annuity option applied to the whole policy value on maturity (including full terminal bonuses) or just to the contractual portion. The Society's practice was to reduce terminal bonuses where the option was exercised, restricting its effect to the contractual policy value only. In most cases this made the option less valuable than the terminal bonuses. Policyholders disputed the Society's right to reduce bonuses in this way.

In February 1999 Mr David Hyman was named as the policyholder representing the interests of GAR policyholders. On 9th September 1999 the High Court ruled that Equitable were entitled to operate their differential terminal bonus policy. Mr Hyman was granted leave to appeal.

On 21st January 2000 the Court of Appeal gave judgement against Equitable by a majority of two to one. The Court ruled that the discretion afforded to the directors of Equitable by article 65 of its constitution did not allow them to allot a lower level of bonus simply because an individual policyholder had exercised his option to receive a guaranteed annuity.

The directors took the view (encouraged by the comments of one of the judges) that the additional cost could be ‘ring-fenced’. This meant that that extra cost would be borne, not by reducing the individual GAR policyholder's terminal bonus, but by reducing the terminal bonuses of GAR policyholders generally. In this way they hoped to restrict the cost to the Society (and to the non-GAR policyholders) to a relatively small sum. The Society's managing director Alan Nash wrote to policyholders expressing this view and estimating the cost at £50 million. Equitable appealed to the House of Lords.

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The House of Lords' judgement on 20th July 2000 confirmed that Equitable could not apply different rates of bonus depending on whether or not the policyholder took benefits based on GARs. It also ruled out the possibility of paying lower bonuses to GAR policyholders as a class, 'ring-fencing'. This meant that the cost had to be borne not by GAR policyholders only, but by the Society (effectively the non-GAR policyholders). Equitable Life's directors estimated the consequential additional liabilities to Equitable, as a result of the House of Lords' decision, had risen from the £50million reported to policyholders to £1,500 million. They immediately announced that they were seeking a buyer.

THE ABORTIVE SALE PROCESS

Equitable also announced that there would be no growth credited to with profit policies for the first seven months of 2000. This was reckoned to cover the cost of the House of Lords judgement. Even so Equitable still had difficulty meeting its technical solvency requirements, acknowledging that the company's position would be unacceptably weak on a continuing basis.

According to the Parliamentary Ombudsman, the prudential division of the Financial Services Authority took the view that 'while a sale could not be regarded as an absolute certainty, it had to be close to 99.9%.' Equitable saw a sale as the only option, and the FSA thought it 'unlikely that they would fail to find a suitable buyer.'

Baird reported ;

4.55.20 When asked in interview whether Equitable Life should have been allowed to continue to write business after the House of Lords' judgment, [then FSA chairman] Howard Davies told us:

"we thought that was likely to produce the best outcome for policyholders, in that closing it to new business at the time would have significantly reduced the value of the company and would have significantly reduced the likelihood of a successful sale, which filled the hole."

4.55.21 Howard Davies also told us in interview (and we believe that he is referring to meetings on 20 July 2000):

"I can't say that there was a lengthy meeting on the subject. But there were a lot of ... corridor discussions at the time because this was a pretty chaotic day because it happened to be our annual meeting. I can remember asking whether we were really confident there were going to be lots of bidders, and at that time we were so confident, and therefore the issue of closure did not seem to be a very likely option to address. I can't say that there was a lengthy consideration of this, but given the promptness of Equitable's response to put themselves up for sale, that, we felt, sort of held the position ... I think if they had shilly shallicked about the future, we would have had time to consider the options much more carefully at that time. But we didn't really."

At the end of August 2000 Equitable's advisers sent to companies who had expressed interest in acquiring Equitable an information memorandum to assist them in their preliminary assessment

Equitable continued to advertise aggressively based upon its (previous) past performance and by the beginning of October the regulators were receiving complaints. The regulators did not feel that they could call for the advertisements to be withdrawn whilst Equitable continued to meet its technical solvency requirements, albeit by a very small margin. The evidence suggests that the policyholders' reasonable expectation that assets would cover aggregate policy values was not considered at this stage.

Equitable reported to the FSA that there were three serious bidders with bids high enough to enable with-profit policyholders to gain restitution for the investment growth they had lost for the period 1 January to 31 July 2000 with additional goodwill on top.

During October and November bidders concerns emerged over the poor state of Equitable Life's finances and the possibility of GAR policyholders being able to pay further premiums, which would make the position worse. The Parliamentary Ombudsman's report includes details of a meeting on 6th October, which illustrates the issues worrying bidder B (and presumably others). Bidder B was concerned that following a change of ownership the regulators might withdraw permission for Equitable to treat as assets in its solvency calculations

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- a) future profits (£925 million in 1999)
- b) the re-insurance arrangement (£1,098 million in 1999)
- c) selling costs (subsequently estimated at £1,000 million by Ernst & Young)

Bidder B was also concerned by

- 1) The fact that the re-insurer had the right to terminate the arrangement if Equitable became insolvent.
- 2) The GAR issue, especially Equitable's practice of allowing policyholders to take retirement benefits at any age between 60 and 75
- 3) The possibility that by including an illustration of terminal bonus in the annual statements provided to policyholders, Equitable might have created an expectation on the part of those policyholders

The Parliamentary Ombudsman's report continues:

'Bidder B [on 15th November 2000] told FSA's prudential division that they felt that, in the light of the results of the due diligence process they had carried out, it would not be worth taking Equitable "at any price". They said that, even if the whole of any purchase price were to be paid in to meet the shortfall in Equitable's funds, a great many policyholders would remain dissatisfied, which would make it impossible to continuing selling to them or to new policyholders under the Equitable name. They also said that some among the current policyholders were expecting a restoration of foregone bonuses and perhaps a demutualisation bonus, expectations it would be quite impossible to meet'. Bidder C notified FSA's prudential division on 4th December 2000 that they had decided to pull out.

At a meeting between Equitable Life directors and the regulators on 6th December, it was agreed that if the final bidder (A) also withdrew then the Society would close to all new business. On the next day the final bidder withdrew and on 8th December 2000 Equitable Life closed to new business

SUBSEQUENT EVENTS

In February 2001 Equitable Life's 'operating assets' were sold to Halifax Group for (as it turned out) £750 million. The term 'operating assets' consisted of the buildings and plant used by the Society, staff contracts, the sales force, computer system and client database. Halifax did not take over the with-profit fund and all its problems.

Between December 2000 and May 2001, the old board of directors resigned and a new board was appointed. A financial review was ordered, which reported in June 2001. This has never been published, but presumably attempted to quantify the problems facing the Society in particular

- a) Covering the costs of the House of Lords GAR judgement (£1,500 million). The freezing of bonus declarations for the first 7 months of 2000 proved ineffective. There were no gains out of which to vote a bonus in the first place.
- b) Capping GAR costs. Interest rates continued to fall increasing those costs.
- c) The asset deficit of £1,400 million at 31st December 2000 (in addition to the cost of the House of Lords' judgement).
- d) The use of 'financial engineering' (future profits, re-insurance arrangements and selling costs) rather than 'real' assets to shore up solvency calculations.
- e) The Society's exposure to a falling stock market. The period from late 1998 until December 2000 when the FT-SE 100 hovered about the 6200 mark turned out to be the top of the long bull market that had run from 1988. In the first 6 months of 2000 the market fell by about 12%.

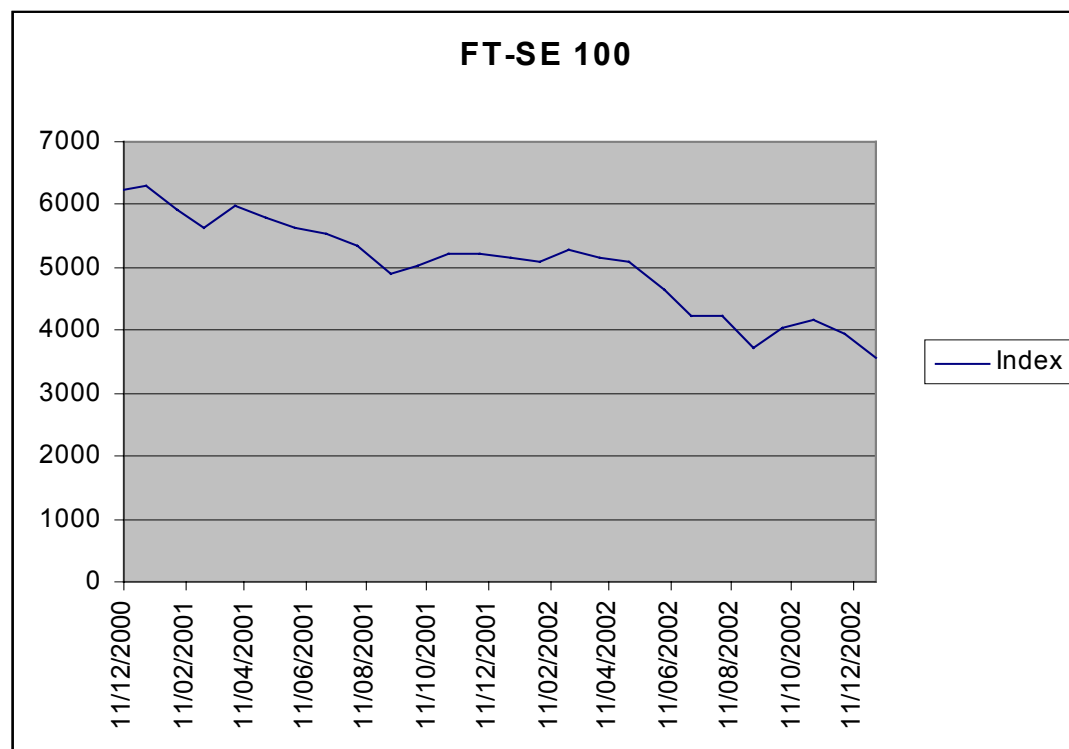
The result was that on 16 July 2001 policy values were cut by 16%. In very round terms this can be attributed more or less equally to three causes:

- 1) the long term asset deficit
- 2) the GAR cost
- 3) the fall in investment values in the first half of 2001 and/or the absence of any 'estate'

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Since 2/3 of the deficit being recovered derived from historic matters but the value cut hit new and old policyholders equally, this 'adjustment' bore unfairly on new (predominantly non-GAR) investors. EMAG had suggested that the GAR cost should be recovered in proportion to terminal bonuses, which would have been fairer, but this suggestion was not taken up. The effect of the 'across the board' cut was to exaggerate mis-selling claims by non-GAR policyholders.

The following chart shows the seriousness of the stock market falls in 2000 and 2002



Over those years Equitable dramatically reduced its holding in company shares, thankfully mostly in advance of market falls. Nevertheless losses on investments were sustained:

Year to 31 st December 2001	£2,471 million
6 months to 30 th June 2002	£ 265 million

The effect upon policyholders was felt when further policy value cuts were announced:

15 April 2002	4%
July 2002	6%

These predominantly reflected investment losses during 2001 and 2002. By the end of 2002 Equitable Life had reduced its exposure to the stock market to trivial proportions. The bulk of its investment portfolio is now in fixed interest stocks.

When the Managing Director wrote to with-profit annuitants in November 2002 it was made clear that the underlying funds of with-profit annuitants had been affected by policy value cuts and bonus reductions in a similar way to those of other with profit policyholders.

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Bonus rates for Pension Policies for 2000 onwards were declared as follows:

Year to 31 st December	2000	2001	2002	2003 (interim)
Overall Bonus	3.3%	2%	0%	3.5% (from 1/4/03)
Reversionary Bonus (where GIR applies)	3.5%	3.5%	3.5%	3.5%
(where GIR does not apply)	0%	0%	0%	0%

In February 2002 the High Court approved a compromise scheme between the Society and the GAR and non-GAR policyholders. In crude terms:

	‘Worth’ (if Equitable had the money)	Accepted
GAR Policyholders – Loss of GAR rights (awarded by House of Lord’s)	About 40%	17.5%
Non-GAR Policyholders – Mis-selling rights (estimated at)	About 10-13%	2.5%

The compromise contained some very ‘rough edges’, particularly as regards those ‘late-joiners’ who invested in 2000 after the Society had lost in the Court of Appeal. The Parliamentary Ombudsman reported that the regulators allowed Equitable to trade during 2000 on the basis that late-joiners would be entitled to special treatment. In the event they did not get any. The Society had to make substantial provision for the cost of their claims in its 2001 and 2002 accounts.

Nevertheless the compromise succeeded in capping GAR costs and reducing non-GAR mis-selling costs. This combined with the re-investment of the Society’s portfolio into fixed interest stocks has stabilised its finances. However the absence of exposure to the stock market limits the prospects for future bonuses from investment returns to about 3.5% p.a. (after administration costs).

There is the possibility of the Society receiving additional income in respect of its claims against:

- a) the old board – unlikely to be large
- b) the old auditors – the claim is huge, but likely to be whittled down
- c) the government – not being pursued with any enthusiasm to our knowledge

Against this there is the possibility of renewed mis-selling claims as more facts emerge.

During the period of falling investment values and low bonuses (2000-2003) it emerged that from about 1996 the old directors had introduced a new series of contracts with no ‘guaranteed investment rate’ (‘GIR’). Prior to that almost all contracts included such a guarantee, typically at 3.5% p.a. While bonuses were good this made little difference, but when bonuses were very low, the 20% or so of policyholders without the guarantee got nothing or what they did get was non-contractual and could be taken away.

As regards the future there are now two classes of policyholders:

- a) Those with the guarantee must be credited with 3.5% bonus every year regardless of investment performance. This would be advantageous were it not for the fact that 80% of policies have the guarantee, so there is no one to pay for it if investment performance doesn’t. Furthermore the Society can only invest in fixed interest stocks to match this guarantee, which limits future prospects.
- b) The directors will no doubt try to ensure that those policyholders without the income guarantee will be credited with a 3.5% bonus anyway. However, such bonus is ‘non-contractual’ and very much at risk if things go wrong.

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EMAG claims to have suggested (at a meeting with directors on 22nd August 2001) that the GIR situation should be addressed at the time of the GAR/non-GAR compromise, but it was not.

ERRORS AND OMISSIONS

With hindsight, it is possible to map out the series of errors that led up to the demise of Equitable Life. It is also possible to identify the opportunities that were missed to minimise the effect of those errors.

- 1) In the design of the original 1957 deferred annuity (GAR) contracts, the interest rate assumptions upon which the eventual annuity would be paid (even at 3% or so) created a risk, which Equitable took up on behalf of the investors in those contracts. A specific charge for this 'service' should have been made in fairness to other policyholders and a provision (albeit small) should have been made for this risk in the Society's Returns and Accounts.
- 2) When in 1975 the interest rate assumptions were increased to about 8% there was another opportunity to institute both a charge for the service and a provision in the Returns.
- 3) The introduction of terminal bonuses in 1975 provided the opportunity to clarify the relationship between those bonuses and the guaranteed annuity option. In short, whether the GAO was instead of or in addition to those bonuses. This opportunity was repeated as GAR contracts were re-written over the following 13 years. Alternatively marketing literature could have at least clarified the Society's intention. This might have made the eventual Court case unnecessary.
- 4) During the 1980s, as interest rates fell, the Society's actuaries had annual opportunities to make provision for the GAR risk, possibly using stochastic methods. This might not have built up an entirely adequate reserve for the major liability that materialised, but it might have accelerated the termination of the GAR contract, diversification from pension business and the reduction of bonuses.
- 5) From about the late 1980s the chances were poor of dealing with the problem by any sort of gradual approach. Too large a proportion of the Society's business had the guaranteed annuity option. Some fundamental changes were needed.
- 6) In 1988 the Society had the opportunity to 'ring-fence' the GAR risk when the old deferred annuity contracts were withdrawn in favour of the new (non-GAR) Personal Pension Plans. It is normal industry practice to allot different bonuses to classes of policies appropriate to the costs involved in each class. (What the House of Lords objected to was the Society's intention to do this retrospectively.) The GAR policyholders would have received lower future bonuses but would have had no valid grounds for complaint. Ring fencing on its own might not have been enough (some cuts in existing GAR bonuses might have been necessary), but it would have protected to some degree incoming (and unsuspecting) non-GAR policyholders. The probable reason why this was not done was the effect it would have had on the 'past performance' figures used for marketing. The performance of the old GAR policies was being used to sell the new non-GAR ones. If the bonuses of the former were reduced, sales of the latter would have been reduced. There might also have been a reluctance on the part of Equitable Life's management to admit the Society had a guaranteed annuity rate problem.
- 7) Some pressure from the regulator at this stage (late 1980s) could have been advantageous, but neither the then regulator (DTI) nor the Government Actuary's Department appears to have been aware of the GAO risk at either an industry or company level.
- 8) The GAO problem might also have been picked up earlier by the actuarial profession generally. 'It is reasonable then for those outside the group of Appointed Actuaries to ask

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why few or no offices had either charged or reserved for these options.... and why the then supervisors did not ask offices whether they had set up the required reserves. Of course, the supervisors may not have known that such benefits were being offered, but one wonders whether they have any obligation to be aware of what is on the market...". (Reserving, Pricing and Hedging for Policies with Guaranteed Annuity Options, A.D. Wilkie, H.R. Waters and S. Yang, presented to the Faculty of Actuaries, 20 January 2003.)

- 9) In 1989 Messrs Ranson and Headdon explained Equitable Life's 'full and fair' distribution policy to their actuarial brethren. The absence of an 'estate' of surplus assets gave Equitable nothing to fall back upon, should trouble strike. The regulator might have taken the hint (then or later) to ensure that proper provision for all known liabilities (e.g. the GAO) had been taken into account before assessing (and distributing) those profits.
- 10) As interest rates fell in the early 1990s Equitable Life's directors had their (last) opportunity to re-organise the Society's portfolio by buying fixed interest investments, which would have more accurately matched its guarantees to GAR policyholders. Instead the directors maintained about 50% of the portfolio in equities, presumably upon the grounds of higher growth potential and to maintain the Society's marketing edge.
- 11) The same falling interest rates gave Ernst & Young, Equitable Life's then auditors, their best opportunity to recommend some provision for the guaranteed annuity option before it went 'in the money' or qualify their report. The risk could no longer be described as trivial and the Society's lack of provision 'could be viewed as being unsound because no explicit provision is made for an explicit guarantee', as the actuarial profession working party described it.
- 12) The long bull market of the 1990s gave Equitable Life's directors the annual opportunity to strengthen the Society's finances, by reducing both reversionary and terminal bonuses, at least to the point that aggregate policy values were represented by assets. The fact that they did not do so suggests that they gave first priority to marketing as opposed to prudence.
- 13) The regulator had annual opportunities to deduce from Equitable Life's weak technical solvency position that the Society did not have assets to cover aggregate total policy values. There was a system in place to review insurance companies' technical solvency, which included only contractual liabilities to policyholders. There seems to have been no system for identifying or monitoring 'policyholders' reasonable expectations' (including terminal bonuses). If there had been such a system, the Government Actuary's Department might have appreciated the reasonable expectations generated by Equitable Life's annual statements of policy values. If so, then that Department might have identified much earlier that the Society's assets fell well below aggregate policy values and that under the Insurance Companies Act it was the regulator's job to use his extensive powers to rectify the position.
- 14) The problematic GAR contracts were mostly written to receive single premiums. The contract wording allowed Equitable to refuse subsequent premiums unless certain minimum amounts were subscribed each and every year. Many policyholders only paid premiums erratically and in practice the Society accepted them regardless. Some tightening of this practice in the late 1980s or early 1990s might have reduced both the size of problem and policyholders' later ability to make contributions even though the GAO was in the money. [By the late 1990s the Society's lawyers advised that the practice was too well ingrained. At that stage a GAR policyholder approaching retirement could pay additional premiums to achieve an annuity rate much better than could be obtained on the open market.]

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- 15) In 1993, when interest rates fell to about the critical level, Equitable Life adopted its 'differential terminal bonus policy', broadly offering retiring GAR policyholders the choice of taking either the GAO benefit on their policy's contractual value or the terminal bonuses, but not both. This policy clearly fitted the Society's view of each policyholder being entitled to his asset share, no more or less. Whether it accorded with the way GAR policies were sold in the seventies and eighties is less clear. The directors do not appear to have considered the possibility of explaining their dilemma to policyholders and seeking a compromise solution. The directors did not take advice upon the legality of what they proposed and things may have turned out very differently if they had.
- 16) In January 1998 the Government Actuary's Department ('GAD') received Equitable Life's confirmation that at 31/12/96, the total face value of policies, including accrued final bonus, was in excess of the value of the assets attributable to with-profits business. The deficit, according to the Society's own figures, was £1,725 million or about 11% of policy values or about half of terminal bonuses. According to the Parliamentary Ombudsman's report 'GAD told Equitable that the above confirmation did not necessarily cause them any concern'. It would certainly have caused the policyholders some concern, if they had been informed, but they were not. The Insurance Companies Act gave the regulator extensive powers to protect policyholders reasonable expectations, but these were not used. Instead GAD merely stressed 'the importance of not building up policyholder expectations too far'.
- 17) From July 1998 until February 1999, FSA's prudential division and GAD negotiated with Equitable Life over the making of full provision for GAO costs. Equitable resisted, threatening a judicial review and achieving ministerial intervention. The result was that although full provision was made, the questionable re-insurance arrangement and an allowance to treat future profits as an asset largely offset its effect. There seems to have been an understanding that Equitable would be allowed to phase in the real cost over an extended period. The argument was not made that about half of the terminal bonuses, that Equitable was claiming to use instead of a provision, were not covered by assets. The Society's directors were not required to face up to their lack of provisions for GAO liabilities and the risks inherent in the asset deficit. The last opportunity was lost to address the Society's weaknesses, whilst the bull market continued.
- 18) In reviewing the 1998 and 1999 accounts, the auditors could have reconsidered the directors' approach to providing for GAO costs in the light of the regulator's view that they were a contractual liability. Had they done so, policyholders would have had a much earlier warning of the Society's difficulties.
- 19) By late 1998, if the GAR policyholders' contention had been accepted, the extra cost of the guaranteed annuity had risen to about 30% or £1,500 million more than Equitable expected to pay. Since the Society already had a shortfall of assets of more than £1,000 million as compared with what it expected to pay, this additional cost could not be afforded. As a mutual, Equitable Life was really just a very big investment club. The costs it could not afford were not to outsiders, but to members. The directors always had the option of explaining the difficulties to the members and seeking a compromise. However this would have entailed a substantial degree of openness and an undoubted loss of prestige and market share. Instead the directors chose to initiate a test case.
- 20) In September 1999 the Society won in the High Court and the case moved on to the Court of Appeal. This court's judgement, delivered on 21st January 2000, was much less satisfactory for the directors. Two of the three judges ruled against the directors' practice of retrospectively reducing individual policyholders' terminal bonuses, if they claimed the guaranteed annuity. However, one judge indicated that the directors might still be able to reduce the terminal bonuses of GAR policyholders generally to reflect the overall cost of the guaranteed annuity ('ring-fencing'). If this were allowed, individual GAR policyholders would have been entitled to opt for the guaranteed annuity on the full value

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of their policy, but that value would still have been significantly reduced. The GAO cost would have been borne by the GAR policyholders as a class, and the effect upon non-GAR policyholders would have been immaterial. The Society appealed to the House of Lords. In the circumstances it is difficult to see what alternative they had.

- 21) There were however other areas when the directors could have reduced the risks by ‘hedging their bets’. Whilst the court case was in progress overall bonuses were voted for 1998 and 1999 (at 10% and 12% respectively) which still meant there was a sizeable asset deficit (£684 million). The directors missed their last opportunity of substantially strengthening the Society’s finances, whilst share prices were still going up. Again marketing considerations no doubt prevailed.
- 22) They prevailed again when the managing director ‘explained’ the position to policyholders in a letter in February 2000, which contained only a very one-sided view of the Society’s financial situation.
- 23) The presentation of the Society’s (effectively the non-GAR policyholders’) case in the House of Lords was hampered by the directors’ reluctance to reveal its inability to pay. As a result, they risked the Society being seen as a big powerful insurance company trying to wriggle its way out of paying policyholders their proper dues. If it had been more open about its finances, it is likely that the House of Lords would have seen it (more accurately) as a members’ club trying to balance the rights of competing classes of members out of a finite pot of assets. Their Lordships could have been asked to express a view on how the GAO costs should be borne. For example, they might have indicated that GAR policyholders should bear a larger share of those costs than non-GAR policyholders, who had enjoyed none of the benefit. Expert evidence could have been called to suggest a formula. Instead the directors continued to give top priority to marketing considerations and this opportunity was lost.
- 24) On 20th July 2000 the House of Lords’ judgement confirmed that Equitable could not apply different rates of bonus depending on whether or not the policyholder took benefits based on GARs. It also ruled out the possibility of retrospectively paying lower bonuses to GAR policyholders as a class (‘ring-fencing’). Equitable Life could not afford to pay and the game was up. If the directors had seen themselves as the committee of a big investment club they could have sought a compromise amongst the members. Instead they put the Society’s business up for sale. No doubt they hoped that the value received for that business would fill up all the financial holes.
- 25) In order to ‘recover’ the GAO cost imposed by the House of Lords the directors ‘froze’ bonuses for the first 7 months of 2000. They reckoned the cost at about 7% of the with-profit fund and if growth was running at 12%, then a seven months’ freeze would do the trick. Sadly this approach failed. The long bull market had ended; the price of shares had stopped going up. The actual result for 2000 as far as with-profit policyholders were concerned was about nil growth, so there should have been no bonus anyway. The ‘freeze’ was totally ineffective in recovering the GAO cost.
- 26) The FSA had the opportunity to close down the Society as soon as it became clear that Equitable Life could not afford the Lords’ judgement. Instead it allowed the Society to continue advertising for new investors, in the hope that the proceeds of the sale would re-balance its finances. This highlights the conflict of interest the regulator faces in trying to maintain a balance between the interests of present and future investors. When the last bidder withdrew in early December 2000, closure was the only option.
- 27) There then followed a very difficult period of about 6 months whilst the old board of directors gave way to the new one. The old board had the opportunity to call an extraordinary general meeting to explain the position to members and to perhaps propose a compromise. If the only problem had been the House of Lords decision, they would

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have found the members sympathetic, but of course it wasn't. In the event, the business of the Society (but not its troubled with-profit section) was sold.

- 28) The new board was confirmed in office in May 2001 on a 'platform' of openness with the members. The new directors soon received what must have been a daunting 'financial review' of the Society. This gave the directors the unenviable task of cutting policy values by about £4,000 million to bring them back into line with asset values. The newly appointed directors had the opportunity to explain the situation openly to policyholders and devise a fair way of sharing the burden. Instead on 16th July 2001 they cut policy values across the board by 16%, placing an unfair cost upon 'newer' policyholders. They also refused to share with policyholders the contents of the financial review, which must question their commitment to the platform of openness upon which they were elected.
- 29) The new directors had another opportunity to remedy this unfairness later in the year, when the GAR/non-GAR compromise was devised. It was not taken. Arguments about mis-selling to newer policyholders are still going on.
- 30) The compromise also gave them the opportunity to deal with the guaranteed interest rate problem. This was also not taken leaving the Society locked into a fixed interest investment portfolio with little growth prospects, even if markets improve.

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CONCLUSIONS

Equitable Life did not go down simply because of bad luck in the House of Lords. There were five major factors, which contributed to its demise:

The Contractual Guaranteed Annuity Risk

In the vast majority of its policies issued up to 1988, Equitable had insured the same risk (the Guaranteed Annuity Option), for which it had made no provision. This meant that reversionary bonuses were too high for the decades of the 1980s and 1990s. Instead of devising ways of meeting this risk the directors effectively passed it on to a new generation of (non-GAR) policyholders (without their knowledge).

When the regulators eventually intervened they were fobbed off with threats of Judicial Review, ministerial intervention and ‘financial engineering’ (future profits, re-insurance arrangements and selling costs).

The Asset Deficit (and consequent undue exposure to risk)

The directors operated an unusual ‘full and fair’ terminal bonus system, which meant that the Society never built up an ‘estate’ of surplus assets (over and above what was earmarked for policyholders). This meant that the Society was always vulnerable to the ‘unexpected’.

The directors then went on to exaggerate this risk, by voting terminal bonuses which were not covered by assets. At almost all year ends during the 1990s aggregate policy values exceeded the value of underlying assets. This ‘asset deficit’ varied from year to year but was typically of the order of £1,000 to £2000 million. Only about half of terminal bonuses was represented by assets, the other half was ‘hope value’. This made the Society very vulnerable indeed to ‘unexpected’ events, like the House of Lords’ decision or falling stock market prices.

The generation of policyholders that retired in the 1990s was paid more than was fair from the money introduced by new investors, lured in by Equitable Life’s unjustified ‘past performance’ record.

The Court Case

In the early 1990s, before the GAO was ‘in the money’, the amounts involved were small, there were few non-GAR policyholders and almost all of the cost would have fallen on the GAR policyholders themselves, there was a good chance of an open compromise. Instead the directors preferred the ‘differential terminal bonus policy’, which was only explained to policyholders (if at all) as they came up to retirement. This set the stage for the litigation of the late 1990s, which the Society lost.

Whilst this was the occasion which triggered the Society’s downfall, its eventual cost was much smaller than it might have been. This is because in the compromise GAR policyholders accepted much less than that to which the House of Lords had decided they were entitled. The Society estimated the total cost at about £900 million.

Even if Equitable Life had won the Court case with the GAR policyholders, it is still likely that the prolonged and serious stock market fall in 2000-2003 would have exposed its weaknesses and brought about its downfall. It had used ‘financial engineering’ to match its contractual liabilities and its smoothing kitty was heavily overdrawn at the top of the market, when it should have been very full. It was in no position to withstand falling share prices.

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Secrecy

The Equitable Life with-profit concept was incapable of existing except under a cloak of secrecy. Would the GAR investors of the 1970s and 1980s have continued to invest if they had realised that the Society had made no plans to deal with the payment of guaranteed annuities? Would the non-GAR investors of the 1990s have pumped so much money into the Society if they had realised both that they were funding a guarantee made to an earlier class of investor and that its 'past performance' included a large element of hope value? Would the investors of the late 1990s with no income guarantee have invested, if they had realised that everyone else was entitled to 3.5% p.a. regardless?

Yet Equitable Life was able to 'play it by the book'. The 'book' was deficient, especially the lack of any requirement for the accounts of with profit funds to be presented separately from the results of the company (i.e. excluding non-profit and unit-linked business but including terminal bonuses). The FSA has talked about such a requirement, but it is still not in force.

Ineffective Regulation

Obviously the directors of the company must bear the major responsibility for what happened, especially the actuary directors, who presumably knew what was going on.

Whether the non-executive directors or the auditors performed their legal duties is a matter currently before the courts. Whatever the outcome, their activities did not prevent the Society's demise.

Neither did the efforts of the external regulators. The old style regulators of the Department of Trade and Industry (later the Treasury) assisted by the Government Actuary's Department simply did not perceive until much too late (1997) that there was a GAO problem at either industry or company level. They took far too long to identify (in 1998) the Society's asset deficit and even then did not appreciate its importance.

A Treasury briefing of December 2000 on the Society's closure raised the question 'Does this event show up a deep-seated oversight on the part of the regulator? - Probably'. On the evidence, the answer should almost certainly be 'yes'.

By the time the new team of the Financial Services Authority (also assisted by the Government Actuary's Department) took over in January 1999 the 'die was cast' as then FSA chairman Sir Howard Davies put it. The critical policies had been written more than a decade before. The options they contained were already well 'in the money'. No effective action had been taken by the Society or the previous regulators to provide for their cost. The court case was under way. The Society had a hefty asset deficit and the stock market was about to stop going up. The chances of disaster were already high.

Earlier appreciation of the full seriousness of the situation by the FSA and earlier closure of Equitable Life would not have 'saved' the Society. It would certainly not have saved its existing policyholders. Indeed it would have denied them the possibility of being saved. It would have saved the losses of the thousands of investors who joined after the House of Lords' decision. The option was not carefully considered.

All of these issues played a part in the downfall of Equitable Life.

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CHRONOLOGY

1957

According to the Baird and Corley reports, Equitable's first life insurance contracts to include a Guaranteed Annuity Rate (GAR) were sold.

Equitable began to include a GAR option based on a current interest rate of 4% for some pension policies allowing the policyholder on retirement to exchange some or all of the benefits the policy provided for an annuity at a rate guaranteed in the policy.

1975

Equitable increased the interest rate on which the GAR was based from 4% to about 8%, where it remained until 1988.

Equitable introduced terminal bonuses for with-profits business; some other companies had already done this.

29/04/88

The Financial Services Act 1986 regulatory regime came into force.

30/06/88

Equitable ceased to offer GARs on new policies.

20/03/89

A paper presented to the Faculty and Institute of Actuaries by Equitable's then appointed actuary said: "we do not believe in the concept of an estate in the sense of a body of assets passed from generation to generation and which belongs to no-one".

10/93

For the first time Equitable's GARs briefly exceeded then current annuity rates and the guarantee became a valuable benefit to those policyholders whose policies were maturing.

22/12/93

Equitable approved their then appointed actuary's proposal to adopt a differential terminal bonus policy.

24/02/95

A Ministerial statement (made in the context of attributing surpluses accumulating in with-profits funds) set out the concept of policyholders' reasonable expectations and the then regulator's view of the factors which influenced these in respect of the attribution of surpluses in with-profits funds.

11/96

The then prudential regulator (DTI) and GAD visited Equitable for a routine regulatory visit as part of a three-yearly cycle of such visits.

01/97

The Faculty and Institute of Actuaries set up a working party to review the GAR option issue and survey the reserving practices of life insurance companies.

04/08/97

Equitable, through a subsidiary, created bonds to fund a £350m loan subordinated to the rights of policyholders.

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The Annuity Guarantees working party of the Faculty and Institute of Actuaries (01/97) considered three possible approaches to reserving for GARs but found that the variation between products and between the approaches of different companies to managing the guarantees was so great that they felt unable to recommend a single approach. They said that not reserving for such guarantees on the grounds that terminal bonus adjustments would be used and were sufficient to cover guarantees in all circumstances [Equitable's then approach] could be viewed as "unsound" because no explicit provision was made for an explicit guarantee.

05/01/98

The Treasury took over from DTI responsibility for prudential regulation. The then DTI staff were seconded to Treasury but remained in their previous location, becoming Treasury's insurance division.

13/01/98

Equitable confirmed that, at 31/12/96, the total face value of policies, including accrued final bonus, was in excess of the value of the assets attributable to with-profits business.

16/01/98

GAD told Equitable that the above confirmation did not necessarily cause them any concern. However, the lack of any unutilised free estate brought to prominence the importance of not building up policyholder expectations too far such that it might then be necessary to hold reserves for anticipated final bonus additions.

20/06/98

GAD initiated a survey of the approach of life companies to reserving for guaranteed annuities.

08/98

From early August the media began to comment about the costs of guaranteed annuities to insurance companies.

09/98

GARs in many Equitable policies were by now some 30% above current annuity rates. FSA's conduct of business division began to receive complaints about Equitable's treatment of GAR options.

08/09/98

Equitable received legal advice that their differential terminal bonus policy might be open to challenge. (This advice was not shared with the FSA.)

10/12/98

Equitable told the Treasury's insurance division that they did not accept the Treasury's view of what constituted a prudent reserve; in the light of favourable legal advice they had received, they were willing to challenge any use of FSA powers through judicial review. Equitable said that they were also pursuing the possibility of reinsurance and wished to meet with the Treasury's insurance division again shortly.

16/12/98

Equitable's Board resolved to initiate a test case in the courts to determine whether they had the right to declare differential terminal bonuses.

18/12/98

The Treasury service level agreement with FSA was signed. The Treasury contracted out to FSA responsibility for most aspects of prudential regulation (certain matters, such as the issue of section 68 orders could not be contracted out and were reserved to the Treasury).

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01/01/99

The Treasury's insurance division transferred to FSA and operated subsequently as part of the Insurance and Friendly Societies Division [FSA's prudential division]. Their legal advisers transferred to FSA's General Counsel's Division.

11/01/99

FSA said that they did not accept that DTI or the Treasury had had notice, as Equitable's Counsel asserted, that the GARs referred to in Equitable's regulatory returns made since 1993 were higher than the current annuity rates.

13/01/99

The Government Actuary issued guidance to all appointed actuaries (reference DAA11) reminding them to make proper provision for all GAR liabilities on prudent assumptions. Reserving requirements would be very similar whether a GAR was the principal benefit or only an option. It was necessary to reserve fully for all alternative benefits offered under the contract

23/02/99

The court ordered that a named policyholder (Mr Hyman) should represent the interests of all policyholders in the matter of GARs, but said that that did not preclude a policyholder from seeking relief based on allegations about the way policies had been sold, if those allegations were based on facts not before the court.

03/99

Equitable rejected an approach made by another mutual life company for the companies to merge and then demutualise.

09/09/99

The High Court ruled that Equitable was entitled to operate its differential terminal bonus policy. Mr Hyman was granted leave to appeal.

21/01/00

The Court of Appeal gave judgement against Equitable by a majority of two to one. The Court ruled that the discretion afforded to the directors of Equitable by article 65 did not allow them to allot a lower level of bonus simply because an individual policyholder had exercised a right to a GAR.

01/02/00

Equitable wrote to policyholders assuring them that the Society remained, and would continue to remain, financially secure. They said that there would be no significant costs for them were the House of Lords to uphold the Court of Appeal's decision.

20/07/00

The House of Lords' judgment confirmed that Equitable could not apply different rates of bonus depending on whether or not the policyholder took benefits based on GARs. It also ruled out the possibility of paying lower bonuses to GAR policyholders as a class [ring-fencing].

Equitable's Board were told that the consequential additional liabilities to Equitable, as a result of the House of Lords' decision, had risen from the previously estimated £50m to £1.500m. Equitable immediately announced that they were seeking a buyer.

06/10/00

The prudential division noted that Equitable had received "three serious offers to buy the group". Equitable's appointed actuary had told them that the bids were high enough to enable with-profit policyholders to gain restitution for the investment growth they had lost for the period 1 January to 31 July 2000 with additional goodwill on top.

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31/10/00

Bidder A assured FSA that they were not behind a rush of recent press reports which seemed to "talk down" Equitable's value, and they still saw the Equitable sales force as a very worthwhile acquisition. However, they believed that the shortfall in Equitable's funds was greater than Equitable themselves had estimated. The company expressed concern that the wording of Equitable's policies allowed GAR policyholders to increase their contributions to the fund, to which the guarantee would attach, thereby increasing the fund's liabilities to the detriment of other policyholders in the fund. They said that they were investigating whether and how that liability might be capped, but said that they were more pessimistic on the issue than were Equitable's directors. They were not yet convinced that they would wish to make a bid.

09/11/00

Bidder B told FSA's chairman that, although they had been very interested in acquiring Equitable, they had reached the view that the financial position was considerably worse than they had first thought, and perhaps rather more doubtful than FSA had been led to believe. While they had not entirely ruled out any possibility of proceeding, they expected soon to tell Equitable that they did not wish to do so.

15/11/00

Bidder B told FSA's prudential division that they felt that, in the light of the results of the due diligence process they had carried out, it would not be worth taking Equitable "at any price".

04/12/00

Bidder C notified FSA's prudential division that they had decided to pull out.

06/12/00

Treasury officials briefed the then Economic Secretary that the last remaining bidder for Equitable was likely the next day to decide against bidding and Equitable would then close to new business, possibly causing a ripple in the gilts market and leaving 650,000 policyholders looking for advice. The main reason that a sale had not taken place was said to be that it was impossible to cap Equitable's GAR liabilities. Equitable were only just meeting their capital requirements, so there was little working capital available to underpin the writing of new business. FSA estimated that the impact of the Lords' judgement would be to reduce returns to policyholders by 10%; however, such returns would still compare well with those of many of Equitable's competitors. While it might be argued that the regulator should have stopped Equitable writing new business sooner, there had until a few days previously been every sign that a sale could be achieved. The regulators had been just as surprised as the markets that no buyer could be found. The briefing said: "Does this event show up a deep-seated oversight on the part of the regulator? Probably." but the briefing added that the oversight was not life threatening until the Lords' judgement, the scope of which had been quite unexpected.

07/12/00

Bidder A withdrew from the bidding process.

08/12/00

Equitable closed to new business.

05/02/01

Equitable announced the sale of their operating business to the then Halifax Group plc who paid £500m, with the prospect of a further sum of up to £500m to follow. Half of the latter sum was conditional on Equitable's policyholders agreeing to cap the GAR liabilities - which they subsequently did - and the remainder on the sales force meeting certain performance targets.

16/07/01

The new Equitable Life board announced a 16% cut in policy policy values

31/08/01

The then Economic Secretary announced the setting up of the Penrose Inquiry.