

FACT-SHEET ON EQUITABLE LIFE

Equitable Members' Action Group

BRIEF FACTS

- A) The Equitable Life Assurance Society is the world's oldest mutual life assurance company.
- B) It was forced to close its doors in December 2000.
- C) The immediate cause was its loss of the Hyman case in the House of Lords, which concerned the Guaranteed Annuity Rate ('GAR') contained in the pension policies it had issued between 1957 and 1988. At the time of the Lords' decision (July 2000) this loss was estimated to cost the Society £1,500m.
- D) In the autumn of 2000 various attempts were made to sell the whole business (principally comprising the with-profit fund), thought by some to be worth billions of pounds. However, on examination of the Society's finances, no one was prepared to buy the business at any price.
- E) In early 2001 the old board of directors resigned and was subsequently replaced by a new board under the chairmanship of Vanni Treves.
- F) The new board appointed Equitable Life's first independent Appointed Actuary Peter Nowell of Bacon & Woodrow.
- G) Following his comprehensive financial review, the Board cancelled interim bonuses and cut pension policy values by 16% (14% for life policies)

LORD PENROSE

Information that has emerged subsequently has shown that the loss of the GAR case was by no means the only factor contributing to the Society's downfall. The main source of reliable information is the independent report by Lord Penrose. He is a senior Scottish Judge and Chartered Accountant. His enquiry took more than two years and cost more than £2m. The report prepared by Lord Penrose and his team of experts runs to over 800 pages and chronicles Equitable Life's history for almost half a century.

His report showed that the Society's directors voted total bonuses such that the grand total of with-profit policy values consistently exceeded the relevant assets. The figures at each financial year-end were as follows:

At 31-Dec	Assets	Aggregate Policy Values	(Deficit)	GAR Provision	Total (Deficit)	As a % of Assets
	A	B	C=(A-B)	D	C+D	D/A
	£m	£m	£m	£m	£m	
1989	4,921	5,166	(245)		(245)	-5.0%
1990	4,903	6,277	(1,374)		(1,374)	-28.0%
1991	6,266	7,805	(1,539)		(1,539)	-24.6%
1992	7,916	9,215	(1,299)		(1,299)	-16.4%
1993	10,880	11,065	(185)		(185)	-1.7%
1994	10,817	12,956	(2,139)		(2,139)	-19.8%
1995	13,366	14,962	(1,596)		(1,596)	-11.9%
1996	15,699	17,424	(1,725)		(1,725)	-11.0%
1997	19,240	20,598	(1,358)		(1,358)	-7.1%
1998	22,367	23,517	(1,150)	(50)	(1,200)	-5.4%
1999	26,139	26,823	(684)	(50)	(734)	-2.8%
2000	25,844	27,401	(1,557)	(1,500)	(3,057)	-11.8%

The figures for the period 1995 to 1999 (inclusive) were extracted from Equitable Life's own internal workings ('the Office Valuation') produced in the Court of Appeal. The amounts for other years are from the same source as reported by Lord Penrose.

FACT-SHEET ON EQUITABLE LIFE

Equitable Members' Action Group

THE EQUITABLE LIFE WITH-PROFITS THEORY

The main feature (and the main advantage) of with-profit investment is the smoothing effect of the bonus mechanism. Unlike a unit-linked managed fund, where unit prices and policy values change daily (sometimes dramatically), the directors of a with-profit office declare periodic bonuses intended to reflect the underlying trend of investment performance. In this way with-profit investors are protected to some extent from market swings. Many with-profit offices reinforce this by maintaining an 'estate' of surplus assets, which 'belongs' to no one. This enables such companies to continue to declare bonuses during market falls.

From the late 1980s Equitable Life tried to combine the benefits of with-profits smoothing with the transparency of managed fund valuations, but without maintaining any estate. The Equitable Life approach was set out in the paper 'With Profits Without Mystery' prepared by Roy Ranson (Appointed Actuary) and his assistant Christopher Headdon and presented to the Institute of Actuaries on 20 March 1989. This described the Equitable Life attitude as being:

'that the business belongs to the current generations of with-profits policyholders. Those policyholders participate in a pooled fund and, when they leave, should take 'full value' from the fund. The fund is continually open to new members. In particular, 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.'

In reply to the debate following the presentation of this paper Mr Ranson put it even more succinctly: 'We take the savings from the current generation, we earn what we can on those savings and pay it out to the current generation.'

The concept did not meet with unqualified approval. One commentator was Mr P. N. S. Clark, then Group Deputy Actuary of the Prudential and subsequently Chief Actuary and Finance Director of AXA Sun Life and President of the Institute of Actuaries 2000-2002. He said 'The authors state in §4.1.1 their belief that "the assets of the office are owned by the current generations of policyholders". I believe that the implication the authors draw from this is that, ignoring smoothing, the sum of individual asset shares for individual policies equals the market value of the fund. This means that smoothing must be a totally balanced concept, that any over-payment to one group of policyholders must be equally and oppositely balanced by an under-payment to another group. Failure to achieve this must inevitably lead to insolvency in the long run if the rest of the theory is left intact.' In short, a with-profit fund with no 'estate' has to 'keep its books balanced'.

THE EQUITABLE LIFE WITH-PROFITS PRACTICE

The Equitable Life directors accepted the importance of balancing policy values with assets, as recommended by Mr Clark. They maintained calculations to make just such a comparison, the Office Valuation shown in the table.

It is immediately apparent from these figures that over more than a decade Equitable did not balance its policy values with asset values. Every year-end comparison shows a deficit. Sometimes the deficits were substantial in percentage terms e.g. 1990 28% and 1994 nearly 20%. Even when the values were almost balanced as in 1993 and 1999 this was as a result of a short lived market spike. At no year-end was there a counterbalancing surplus.

Of course, excess terminal bonuses relating to continuing policies could be 'recovered' by bonus cuts at any time before those policies matured. More insidious was the cumulative effect of consistently paying away to departing policyholders more than had been earned on 'their' investments.

In no sense can it be said that policyholders were getting a return equivalent to a smoothed version of what the Society earned, as Messrs Ranson and Headdon had proposed in 'With Profits Without Mystery'. What Equitable Life's directors did during the 1990s was to vote consistently more by way of bonus than had been earned on any particular generation's investments. Over-payments to groups of departing policyholders were nowhere near equally and oppositely balanced by under-payments to

FACT-SHEET ON EQUITABLE LIFE

Equitable Members' Action Group

other groups, as suggested by Mr Clark. He rightly predicted that failure to achieve this balance in the long run would end in tears.

The policy of declaring total bonuses in excess of actual investment performance encouraged hundreds of thousands of innocent new investors and (as the table shows) the Society expanded hugely. Assets increased from £4.9 billion in 1989 to £25.8 billion in 2000.

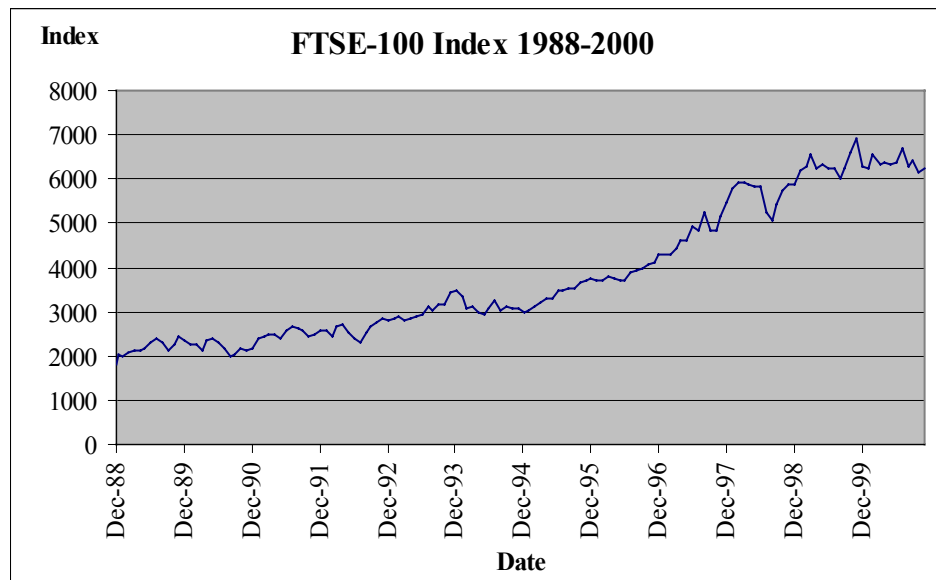
Equitable Life's senior management clearly recognised the risks they were taking. In 1997 Mr Headdon attempted to quantify the loss that was accumulating from the subsidies paid out to retiring policyholders (including subsequent investment return foregone). Lord Penrose's team extended the figures to 2000 using Mr Headdon's methodology and they are shown below:

Year	£m		Year	£m
1990	69		1996	902
1991	214		1997	1,196
1992	362		1998	1,451
1993	499		1999	1,728
1994	528		2000	1,834
1995	741			

In round terms, during the decade prior to its downfall the cash lost by the Society as a result of excessive bonuses to leavers amounted to something like £1,800m. This obviously impacted upon its finances and made it too weak to withstand the loss of the GAR case and the likely outflow of another £1,500m.

THE STOCK MARKET

During the 1990s the stock market enjoyed its longest and strongest 'bull market' in living memory as can be seen from the chart.



The short-lived 'spikes' that temporarily allowed Equitable Life's management to (almost) 'balance the books' at December 1993 and December 1999 can be seen very clearly. For example, at 31st December 1999 when the index briefly stood at 6930, the Society had £16,500m in equities. Revaluing these at a more representative 6300 would reduce their value (and increase the asset/policy value deficit) by about £1,500m.

FACT-SHEET ON EQUITABLE LIFE

Equitable Members' Action Group

THE 16% POLICY VALUE CUT

The Office Valuation shows that at 31 December 2000, Equitable Life's policy values exceeded its assets by about 12%. During the first half of 2001 :

- a) The old board's attempt to recover GAR costs by freezing bonuses in the last half of 2000 was seen to have failed. Markets had not produced the required increase in asset values.
- b) The old board resigned and a new one was appointed.
- c) Some of the Society's assets were sold, but not the with profit business.
- d) Policyholders were leaving in increasing numbers.
- e) The stock market fell by about 9%. This had the effect of reducing the Society's asset values by about 4%. (Something under half of the Society's investments were equities)
- f) The Society's first really independent Appointed Actuary (Peter Nowell of Bacon & Woodrow) undertook a comprehensive financial review.

The new directors have never published the financial review, and they did not permit even Lord Penrose unrestricted access to their current papers. However, we know that :

- 1) At the beginning of 2001 assets fell short of policy values by about 12%
- 2) Interim bonuses were still being added to policy values at 8% p.a. (4% for the half year)
- 3) Asset values fell by about 4% for the half-year.

This meant that by the end of June 2001 the asset shortfall had increased to about 20%, departing policyholders were taking more than their 'fair share' and something had to be done.

On 16th July the board announced its decision to cancel the interim bonus and to cut policy values by 16%. It subsequently emerged that Peter Nowell had advised the new board that policy and asset values should in future be kept in balance, subject to a margin of about 5% either way. The fundamental need for balance in a with-profit fund had finally been re-asserted.

SUMMARY

The facts as revealed by the various reports show that Equitable Life failed for a combination of reasons, including:

- a) A long history of voting bonuses in excess of the investment returns actually achieved. Using Mr Headdon's own methodology, Lord Penrose calculated the accumulated cash cost of this at about £1,800m
- b) A similarly long history of understating liabilities. Lord Penrose found that its annual returns to the regulator contained various 'practices of dubious actuarial merit'.

This meant that the Society was simply too weak to withstand:

- c) The House of Lords' judgement on the GAR issue which, the Society estimated, would cost it about £1,500m.
- d) The relatively modest Stock Market fall of 2000. When the Society had to close its doors to new business on 8th December 2000 the FTSE-100 still stood at 6288.

The business could not even be sold. Prospective purchasers soon found that the cost of replenishing Equitable Life's finances was more than its business was worth. The world's oldest mutual insurer had been so weakened by its 1990s management that it could not be sold at any price. In the absence of a purchaser with very deep pockets, closure became inevitable.

As the position deteriorated in the first half of 2001, the new directors had no option but to take strenuous action as soon as they could estimate the total deficit. The deficit figure they came to was something in excess of £4,000 million and the remedy they chose was to cancel interim bonuses and to cut policy values by 16%.

FACT-SHEET ON EQUITABLE LIFE

Equitable Members' Action Group

EQUITABLE LIFE'S CURRENT VIEW

The 'facts' set out by Equitable Life in its recent 'fact-sheet', (The Penrose Report - Policy Value Reductions and Alleged 'Over-Bonusing') assert that:

1. The 2.8% deficit shown by the Office Valuation can be disregarded and the fund treated as broadly 'in balance' at 31st December 1999.
2. During the period between 31st December 1999 and 30th June 2001, the Society suffered a negative investment return of 7.9%, which together with bonuses declared (3.3%) and provisions for increased life expectancy (1.0%), produced a total deficit for that period of about 12.2%
3. The fund was actually in surplus of 2.4% immediately after the 16% cut. Consequently only 13.6% could apply to any earlier period.

The unnamed author concludes that since virtually the whole of the net 13.6% cut can be attributed to the period between December 1999 and June 2001, no material part of the cut can possibly relate to the Society's long record of financial improvidence over the previous decade. These 'facts' can all be refuted as follows:

1. The FTSE-100 index at 31st December 1999 (6930) was a spike on top of the massive bull market that ran for most of the 1990s. For this reason it is the least suitable starting point for any financial calculation, particularly a 'smoothing' one. If one must use this date, it is appropriate to make an adjustment for the spike. Such an adjustment would reduce the assets and increase the deficit by about £1,500 million (5.5%). The Office Valuation (2.8% in deficit) also counted as an 'asset' the 'new business loan' of £280m, which was rightly withdrawn from subsequent calculations and took only £50m as the GAR liability, which the accounts estimated at £200m. Adjusting for these (2%) and the spike produces a more representative opening deficit of 10.3%, which could hardly be dismissed as being 'in balance'.
2. The negative 'investment return' of 7.9% during the eighteen months from December 1999 to June 2001 has been arrived at after deduction of the GAR cost. Since, at the time the GAR cost was estimated at something like £1,500 million (about 5.5%), even using Equitable Life's figures, most of the alleged negative investment return had nothing at all to do with investments. Indeed, after adjusting for the GAR and the spike, the Society had a small positive investment return over the period.

Given that, after adjusting for the 'spike', the stock market was still very high in 1999, it is reasonable to assume that even an insurance company intending to pay out 'full profits' should have had something in its smoothing kitty for the inevitable rainy day. The loss of the GAR case in the House of Lords in July 2000 was just such a rainy day.

3. The claim that the Society was in surplus immediately after the 16% cut (14% for Life policies) seems to be based upon some understandably 'rough and ready' calculations prepared at the time. In particular, the assumption seems to have been made that the whole of the 16% would be recoverable by the Society. [Table 6.14 on page 223 of Lord Penrose's report shows the bonus freeze (about 4%) and policy reduction (about 15%) at £4,895m, being 19% of £25,849m, the sum total of policy values at the time.]

In fact, recovery was limited to those policies which had a 16% terminal bonus element and there were many, commenced in the late 1990s, which did not. The balance of the 16% cut could only be recovered quickly by the Society if the policyholder took a non-contractual exit. Many avoided this non-contractual exit 'penalty' by taking their pension once they reached age 50.

We are confident that the policy value cut was correctly recorded in the Society's accounts and regulatory returns. In our view, the current fact-sheet regurgitates a rough calculation that has long since been corrected in more considered statements. We believe the sum 'over-claimed' to be of the order of £700 million to £900 million (about 3%).

FACT-SHEET ON EQUITABLE LIFE

Equitable Members' Action Group

We have shown below, what we believe to be, a fairer presentation of what happened (using Equitable Life's own numbers, which we do not necessarily endorse):

	A Fairer Presentation		Equitable 'Fact-sheet'	
Policy Value Cut		13.0%		16.0%
Deficiency Between 31 Dec 1999 and 30 June 2001				
Investment Return	3.1%		-7.9%	
Additional Provisions	-1.0%		-1.0%	
Bonuses	-3.3%		-3.3%	
	-1.2%		-12.2%	
Surplus after the Cut	0.0%		-2.4%	
		-1.2%		-14.6%
Balance of the Policy Value Cut		11.8%		1.4%
Deficiency at 31 December 1999		10.3%		0.0%
Cut relating to the period before December 1999		10.3%		0.0%

The revised presentation supports Lord Penrose's considered view that the 16% cut of July 2001 was an attempt to claw back previous over-bonusing. In our view, the Equitable Life 'fact-sheet':

- Adopts an unrepresentative starting date, 31st December 1999, when the FTSE-100 stood at its all-time high, and fails to make an appropriate adjustment.
- Uses inaccurate figures, which have since been superseded, for the position immediately following the 16% policy value cut.
- Deducts the GAR cost of 5.5% in arriving at an 'investment return' of -7.9%.

As a result it comes to an entirely erroneous conclusion.

THE PERFORMANCE OF OTHER INSURERS

The Equitable Life 'fact-sheet' seeks to equate the loss suffered by its policyholders on 16th July 2001 with losses suffered by the holders of other companies' products arising from falls in stock market values in 2002 and 2003. In our view this is inappropriate. The FTSE-100 was high when the Society closed on 8th December 2000 (6288) and was still relatively high when policy values were cut on 16th July 2001 (5537). Subsequent falls are irrelevant to the loss occasioned by that cut.

