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 the 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 policy values by 16% or about £4,000 million.

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 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,

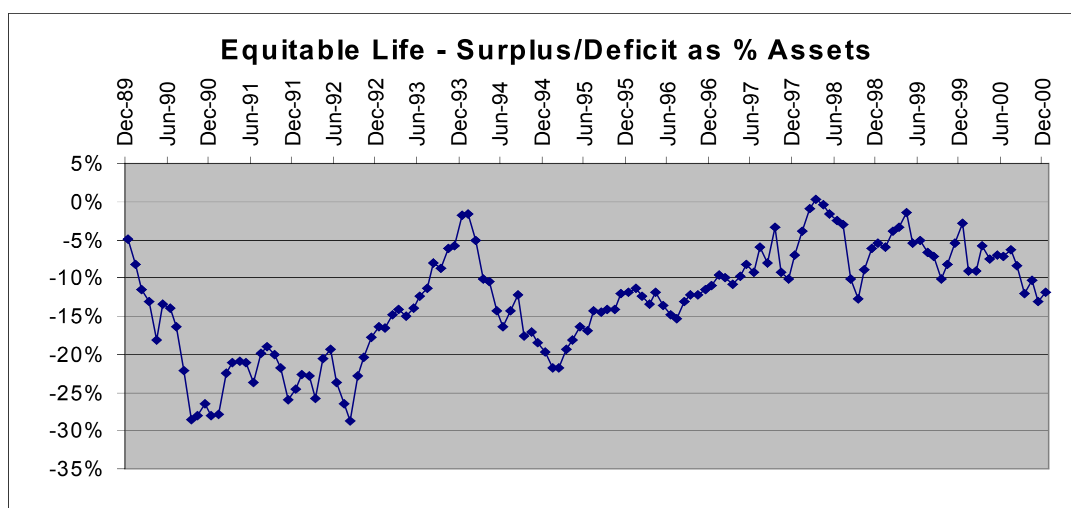
that any over-payment to one group of policyholders must be equally and oppositely balanced by an under-payment to another group. Failure to achieve this must inevitably lead to insolvency in the long run if the rest of the theory is left intact.'

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'. Lord Penrose disclosed these valuations. 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. The table below shows the assets, policy values and deficits at each 31st December from 1989-2000.

At 31-Dec	Assets A	Aggregate Policy Values B	(Deficit) C=(A-B)	GAR Provision D	Total (Deficit) C+D	As a % of Assets 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%

From this we have constructed the following chart of the deficit for the period using Equitable Life's year-end numbers interspersed with monthly estimates based upon movements in the FTSE-100 Index.



It is immediately apparent from these figures that over more than a decade Equitable did not balance is 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 Profit 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 other groups, as recommended 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 the Society expanded hugely. Assets increased from £4.9 billion in 1989 to £25.8 billion in 2000.

THE COST OF OVER-BONUSING

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. Lord Penrose's team extended the figures to 2000 using Mr Headdon's methodology and they are shown below:

Year	£m
1990	69
1991	214
1992	362
1993	499
1994	528
1995	741

Year	£m
1996	902
1997	1,196
1998	1,451
1999	1,728
2000	1,834

In round terms, during the decade prior to its downfall the Society paid out in cash something like £1,800m more than it had earned. 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.

On 27th June 2001 the new board of directors heard Chief Executive Charles Thomson's view of the level of surplus he would have expected at the end of 1999 / the beginning of 2000.

'CGT commented that at the beginning of 2000, the excess of policy values over the value of assets was approximately 3 per cent, which would have been within the acceptable range. In response to a question, CGT confirmed that under normal actuarial principles he would have expected there however to have been an excess in the value of assets over policy values of perhaps 6 or 7 per cent at that time.' (Extract from Board minute read in Court)

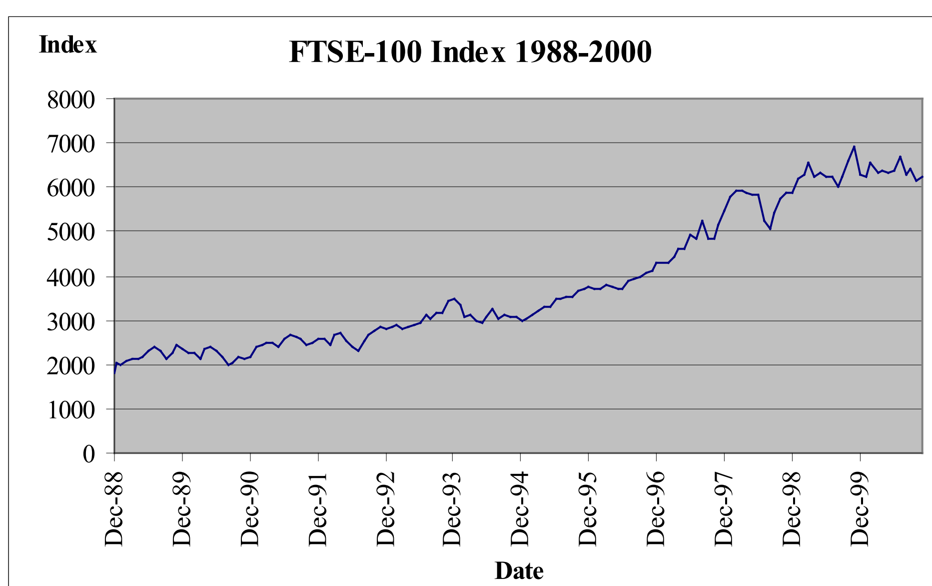
On the 31st December 1999, policy values exceeded assets by about 3%; i.e. there was still an asset deficiency. This is the date when the FTSE-100 index peaked at 6930 at the top of the spike on the top of the long 1990s bull market.

Using Charles Thomson's yardstick, at the beginning of 2000 the Society was short of assets (or had voted excessive bonuses) of about 10% (3%+7%) or £2½ billion. The loss of the GAR case in July 2000 increased this shortage to £4 billion. This was approximately the amount recovered by the 16% cut of policy values on 16th July 2001.

Three different approaches to measuring over-bonusing produce a remarkably consistent result:

Source	Method	Amount
Chart – Deficit as % of Assets	Deficit 1997-2000 fluctuating about 7.5% of fund	£2,000m
Lord Penrose/ C Headdon	Accumulating cash outflow	£1,800m
Charles Thomson	Absence of surplus at market peak	£2,500m

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.

The FTSE-100 still stood at 6288 when the Society closed to business in December 2000.

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%.

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 much 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.

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 (by about £2,500 million) 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%.

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