

OPTIONS FOR EQUITABLE LIFE

Equitable Members' Action Group

INTRODUCTION

We have been asked to produce a brief note for the EMAG committee on the strategic options for Equitable Life following the abandonment of the litigation against the old auditors Ernst & Young. This note has been prepared without any assistance from Equitable Life, apart from available public statements. On grounds of brevity and readability, we have simplified technical issues and approximated to £ billions.

The Society is in a somewhat better balanced position than it was 5 years ago. The Guaranteed Annuity Rate ('GAR') problem was dealt with by the compromise and most of the potential litigation (against the Society) is settled or out of date. However, the Society still has several fundamental problems, including the absence of a significant margin of surplus assets, the Guaranteed Interest Rate ('GIR'), the absence of equity exposure and the onerous administration agreement with Halifax.

In their letter to policyholders of 2 December 2005 Chairman Vanni Treves and Chief Executive Charles Thomson say managing the run-off of the existing policies is now very much a viable strategy. Nevertheless, persistent press reports and the appointment of new public relations consultants suggest that a break-up strategy is also possible. The basic options under consideration appear to be:

- 1) For Equitable Life to continue solely to administer the existing policies for the remainder of their lifetime – 'Running off'.
- 2) Closing down Equitable by transfer of its policies (in whole or in batches) to an Insurance Company (or companies) with continuing business. It was reported in November 2005 that The Prudential is interested in the 'book' of conventional fixed annuities (about £5bn) and the With-Profit annuities (reportedly £2bn), but this has not been confirmed.
- 3) Closing down Equitable by transfer of its policies to one or more of the companies specialising in running off funds that have closed for new business (as Equitable Life has) - sometimes referred to as 'zombie funds'.

Before considering the options, various matters require further explanation.

ANNUITIES

Annuities represent about half of the Society's current business.

a) Conventional Annuities

With a conventional annuity, the insurance company receives a capital premium and undertakes to pay a fixed regular sum for the annuitant's life. The risks the insurer takes derive from the assumptions it makes at the outset about the investment return on the capital and the annuitant's life expectancy, which together dictate the amount of the annuity. If these assumptions turn out to be optimistic, then the insurer bears the cost.

Equitable Life was a competitive player in the conventional (fixed) annuity market. This enabled the Society to provide a service to its pension policyholders as they retired and to add bulk and perhaps profit to its with-profit operation. Although no new annuities have been written for 5 years, conventional annuitants are not able to move their policies and the Society still has conventional annuity business of the order of £5bn.

The attractiveness of this 'book' to a purchaser depends upon its profitability. This depends upon the accuracy or otherwise of the original investment return and longevity assumptions. Our previous work suggested that Equitable Life's book was vulnerable to falling interest rates

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and annuitants living longer than expected. Even so, it is a substantial amount of business, which might be attractive to another insurance company. It could well be sold as a separate entity from the with-profit business. Any profit or loss on sale would accrue to the with-profit fund.

Conventional annuitants would probably feel happier if their future income depended upon a stronger company than Equitable Life.

b) With-Profit Annuities

With-Profit annuities are a more complex product than conventional ones. The essence of a with-profit annuity is that the investment risk (through the mechanism of the with-profit fund) is taken by the annuitant, not the insurance company. It is the annuitant, who makes the investment assumption and it is he/she who suffers the cost if the with-profit fund does badly. In Equitable Life's case, it wrote many with-profit annuity contracts in the 1990s when investment returns were high and such annuities were constructed upon the assumption of continuing high returns, reportedly of the order of 6-7½% p.a. The Society's financial problems and the stock market fall of 2000-2003 have meant that with-profit annuities have been materially cut, mostly by about one third. Furthermore, reduced investment returns mean that the Society's future bonus rate is likely to be about 3½% p.a., roughly half what was expected. Since the Society is locked into fixed interest investments, the stock market recovery of 2003-2005 has not 'rescued' with-profit annuitants. As things stand, they can expect their annuities to carry on declining for the rest of their lives.

The continuing negative publicity that inevitably accompanies such a situation, makes the with-profit annuities (reportedly £2bn) deeply unattractive to a purchasing insurance company.

The Society has been asked to present options to with-profit annuitants to allow them to move their 'pot' to another insurer, to convert to a conventional fixed annuity or to restructure their with-profit annuity to recognise the realities of the Society's current financial position. The Equitable Life directors have always been unenthusiastic about these proposals, perhaps because they know they would all entail an immediate cut in the amount of annuity payable.

UNIT LINKED BUSINESS

Although still appearing in the Society's accounts, the risks and rewards of its original unit-linked business have been effectively transferred to HBOS, since 2001.

THE GIR

The Guaranteed Interest Rate ('GIR') probably still applies to about ¾ of with-profit policies. Policyholders who have the GIR 'enjoy' a 3.5% annual increase in the guaranteed value of their policies. It has been the board's practice to vote a similar (but un-guaranteed) increase to policyholders without the GIR. This is presumably on the basis that, if it differentiated against non-GIR policyholders, then they would have a very good claim for mis-selling. The overall effect of the GIR is that the Society is locked into investment in government stocks and loans, which can (just about) produce a 3.5% annual return. This has meant that the Society has not benefited at all from the Stock market recovery of 2003-2005. The FT-SE 100 index has increased from about 3600 in March 2003 to about 5500 in December 2005, an uplift of more than 50%.

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SOURCES OF POSSIBLE ADDITIONAL ASSETS

EMAG campaigned for Ann Abraham, the Parliamentary Ombudsman, to report on whether the Government should pay compensation in respect of its allegedly deficient regulation of the Society during the 1990s. She is about to report. Equitable Life is a potential beneficiary, but at this stage it is impossible to say, whether the Ombudsman will find mal-administration, whether any compensation will be paid and how much, if any, of it will go to the Society.

Over the years, the Society has made substantial provisions in its accounts for potential claims against it by policyholders. We have no means of assessing, what provisions have been or are likely to be utilised. If, in fact, the total amount actually paid to claimants is less than the original provision, then the excess will be 'written back' and effectively increase the assets available to the with-profit fund.

ADMINISTRATION

In early 2001, the old directors sold Equitable Life's infrastructure (staff, offices, client-list, investment team, computer systems etc.) to the Halifax, now HBOS plc. This left Equitable itself as a 'virtual society', with only the directors, a handful of support staff and responsibility for the flawed with-profit fund and the conventional annuities.

The details of the sale agreement are 'confidential' and have not been published. They reportedly include some terms disadvantageous to the Society. We understand that the administration of the with-profit and annuity businesses is sub-contracted to HBOS on some sort of 'cost' basis. Such arrangements are frequently unsatisfactory. Those providing the services have no direct responsibility to the main contractor's customers and little incentive to minimise costs.

In the case of Equitable Life/HBOS, examples include:

- a) The difficulties the Equitable Life directors have had improving service to policyholders. Charles Thomson may be Chief Executive of Equitable, but the people in the offices at Aylesbury work for HBOS.
- b) The final-salary staff pension scheme has needed topping up in the past and may well do so again. It probably needs re-structuring, but with the staff now working for HBOS, and Equitable Life bearing the cost, it may not happen

RE-STRUCTURING

Whatever is being sold, a car, a house, a small or large business, in our experience, it is best to attend to any obvious faults before presenting the asset to the market. If Equitable Life's businesses (or some of them) are to be sold, it makes sense to resolve their structural problems first. Examples are the GIR and With-Profit Annuities.

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Ironically, Equitable Life's financial weakness gives it one very big advantage over any purchaser. It can propose a compromise to re-write its contracts and reasonably expect its policyholders to approve it. No prospective purchaser could say the same. He must expect to pay some 'premium' to restructure policies. Policyholders know that Equitable Life cannot afford any such premium, but a purchaser could. In practice, a purchasing company would see little benefit to itself in such restructuring and policyholders would probably be permanently locked into the current strategic disadvantages.

So, restructuring now:

- 1) could give policyholders revised contracts both reflecting current realities and more suited to their needs
- 2) could make the re-constructed business easier to sell
- 3) might obtain a better price

TRANSFER OF WITH PROFIT BUSINESS TO A LIVE FUND

One of any insurance company's biggest costs is that of acquiring new business. Commissions, set-up and regulatory costs are substantial and have to be incurred at the outset. 'Economies of scale' are one way of reducing acquisition costs and this has been behind the trend towards bigger insurance groups. These factors can make any large block of business attractive to a purchaser, even if the current proprietor cannot himself run it economically. Consequently Equitable Life's £10bn With-Profit business has some value of its own.

Against this, any reputable insurer would want some 'price' for incorporating Equitable Life with-profit policyholders into their fund. The Society's policyholders would not be bringing any material margin of surplus assets and a purchaser would want to avoid watering down its own policyholders' margin. With-profit annuitants have the additional problems explained above.

Somewhere there may well be a deal acceptable to both parties.

The main advantage to with-profit policyholders in being switched to another insurer is that of bringing their money under a rather more secure roof than Equitable Life's and the prospect of benefiting from a proportion of equity investment.

TRANSFER OF WITH PROFIT BUSINESS TO THE RUNNING OFF SPECIALISTS

The raison d'être of these specialists is to extract profits from the running off of failed funds. Funds with contracts containing hefty administration charges are particularly attractive to them. Equitable Life is not obviously attractive, because its administration costs (and indirectly the charges assumed in its policies) were the lowest in the industry. Nevertheless, the volume available could be of interest and the specialists are likely to be less sensitive to policyholder complaints (e.g. from with-profit annuitants) than an insurer with a continuing business.

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A piecemeal sale to these companies is unlikely to be of significant benefit to policyholders. Conceivably, the specialists might accomplish the run-off more professionally than a closed fund. They can offer their staff a continuing future, whereas a closed fund can only offer a lingering career death, with the predictable result that the best people leave.

CONTINUING AS A MUTUAL

Equitable Life's known strategic problems are:

- a) Having failed to get anything out of the auditors, Equitable Life does not have any significant margin of surplus assets.
- b) The Guaranteed Interest Rate ('GIR') limits Equitable Life's portfolio to predominantly fixed interest investment, Government stocks and loans, with no real growth potential.
- c) a) & b) mean Equitable Life cannot operate as a conventional With-Profit fund with about half its assets in stock market equities.
- d) The With-Profit Annuitants have the prospect of being locked into a declining income for life.
- e) The administration agreement with Halifax has (we understand) some unpublished onerous clauses.

The board has confirmed that it 'continues to evaluate future strategic options'.

QUESTIONS FOR THE DIRECTORS

The outcome of the current strategic considerations/negotiations is of vital interest to continuing policyholders. At one end of the scale, they could find themselves within a live fund, with a real prospect of future growth; at the other end, they might end up in a zombie fund with no growth prospects, run by a company concerned primarily with extracting profit from their contracts. Before approving any transfer proposals we recommend that the directors be posed the following questions:

- a) The Society has a £5bn portfolio of conventional annuities. Its profitability depends mainly upon the in-built investment return and life expectancy assumptions. If it is profitable, then it could either be retained to generate an ongoing stream of income or sold to crystallise a capital profit. Both routes would benefit the with-profit fund. If the portfolio is unprofitable, then it is something that the Society cannot afford and it might be better to dispose of it to another insurer, even if this means paying a 'dowry' for the purchaser to take it away. What is the situation?
- b) The combination of the GIR and the absence of any surplus assets has meant that Equitable Life with-profit policyholders have not benefited from the recent rise in the stock market. Is the GIR more trouble than it is worth? If so, should it be 'compromised away' for everyone's benefit?
- c) Now that, according to Messrs Treves & Thomson, the Society's financial position has improved, can its investment portfolio be revised to enhance growth prospects?
- d) Over the last 5 years many older policyholders, with substantial funds have transferred their investment elsewhere. Apart from the with-profit annuitants

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(about £2bn), the rest of the with-profit fund (£8bn) must have a sizeable proportion of younger (under-50) policyholders. Individually their investments may be small, and they are not vociferous. However collectively they might represent £2-4bn of the fund. The present investment portfolio is seriously disadvantageous to them. They are young enough to take the risk of a material investment in equities, but have missed out on the 2003-2005 uplift. If this approach continues they will miss out on future growth too. Should they be encouraged to switch to unit-linked investment, where the mix of investments could be arranged to meet their needs more appropriately?

- e) Many older with-profit annuitants and those with smaller funds might be better off with conventional annuities. Although this would in most cases involve an immediate cut in income, it would give them the certainty they currently lack. Could they be offered this option?
- f) Other with-profit annuitants, the younger ones and those with larger funds, might prefer to move to some form of managed pension in order to get them out of the fixed interest straightjacket that currently restricts their fund growth. Could they be offered this option?
- g) Some other with-profit annuitants might prefer to accept an immediate cut in income in exchange for the probability of future growth, rather than decline. Could they be offered this option?
- h) The administration agreement with Halifax (now HBOS) allegedly contains onerous clauses. The directors have refused to publish it. Would it help for EMAG to campaign for the agreement to be published and to put pressure upon Halifax to allow re-negotiation?
- i) Some of the Society's current problems clearly derive from the structure of its policies (e.g. the GIR) and from past investment assumptions, which have proved unrealistic (e.g. With-Profit Annuities). These are matters between the Society and its policyholders. Could these be resolved by another compromise? Would it be better to carry out necessary restructuring before transfer to another company? Would this give the directors a more attractive business to sell, on better terms?
- j) Re-structuring upon the lines described above, providing policyholders with revised contracts more accurately reflecting their needs, would remove the incentive for policyholders to take their money elsewhere. Policyholders would not have to pay one penalty to get out of Equitable Life and another to get into Prudential, Norwich Union, Standard Life etc. As a mutual, policyholders would retain some sort of control over their destiny. Would the Society even have prospects of re-opening as an independent mutual?
- k) Can any compromise documentation please include details of the numbers of policyholders and contracts involved and a proper, recent 'Statement of Affairs' (e.g. the Office Valuation)?

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CONCLUSION

Equitable Life's problems are serious and deep-seated; they will not be easily solved. Transfers to other insurers could be of benefit to policyholders, but a reconstruction of the Society's business on its own or in conjunction with a transfer to another company is worthy of consideration. Our recommendation is that EMAG raises the questions set out above.

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