

THE TRANSFER OF WITH PROFIT ANNUITIES TO THE PRUDENTIAL Equitable Members' Action Group

INSTRUCTIONS

EMAG has asked us to prepare a brief paper summarising the proposal for the Prudential to take over Equitable Life Assurance Society's book of With Profit Annuity contracts. It has been agreed that in the few days available to us it is not possible to conduct an in depth examination of the proposal nor to obtain supplementary information from the Society.

EMAG has many members who are with-profit annuitants and this paper is geared towards their interests. It should not be read as advice to individuals. In the interests of brevity and readability, we have simplified technical issues and approximated to £billions

THE 2001 COMPROMISE

Equitable Life policyholders have reason to be wary of the claims made for reorganisation proposals and of the limited information supplied to them. The 2001 Compromise successfully mitigated the claims of GAR and non-GAR policyholders, but did not return the Society to financial good health. This is because its problems went beyond those which the Compromise addressed, in particular its practice of declaring bonuses out of all proportion to profits - over bonusing. Over bonusing was first brought to light in our March 2003 report to EMAG prepared from public sources. This estimated that the Society ran a £1bn deficit of assets against policy values going back to 1990. The scale of this deficit was confirmed a year later by Lord Penrose working from the Society's own documents.

More recent confirmation has been provided by the Disciplinary Tribunal of the Institute of Actuaries which on 30th January 2007 expelled Equitable Life's Appointed Actuary (1982-1997), Roy Ranson. It found that he:

- consistently failed to apply an appropriate smoothing policy
- failed to provide appropriate information to the Society's board to enable proper consideration to be given to the consequences of his recommendations
- failed to maintain the publicised relationship between the investment reserve and total policy values notified annually to policyholders.'

The Tribunal positively linked Mr Ranson's failures to the shortage of means to meet unexpected challenges:

'When there was a sudden call for funds such as when the GAD required reserves to be strengthened or when the House of Lords disagreed with an interpretation of the powers of directors, the company was in extreme difficulty. Neither of those two events occurred during the period that Mr Ranson was Appointed Actuary but the financial events which caused the shortage of funds certainly did.'

Equitable Life's long history of over bonusing was not dealt with in the 2001 Compromise documentation by the Directors or by the then Independent Actuary.

Equitable Life's pronouncements need to be read with a degree of scepticism.

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THE PROCESS

Given that this is a very complicated deal and that as far as With Profit annuitants are concerned, it will affect their income for the rest of their natural lives, the time allowed for them to consider it is simply inadequate. Most policyholders received the documentation on the 29th September. Votes have to be with Equitable by 24th October. This gives policyholders about three weeks in which to make up their minds. Most are old and will need help. Any wishing to take professional advice will be giving their advisers inadequate time to study hundreds of pages of documents.

The Policyholder Circular is dated 14th Sept, which suggests it should have been sent out two weeks earlier, but for some reason was not. This might have been related to the run on the Northern Rock which was then in progress. The rest of the schedule has not been changed. The time available to policyholders has just been reduced by two weeks.

There are no special voting arrangements. The rules set out in the Society's articles will apply. Essentially every policyholder gets 10 votes; only those with policies worth less than £10,000 have their voting rights scaled down. Annuities are valued for this purpose at 10 times the annual payment (excluding bonuses). A simple majority is sufficient to make the transfer to the Prudential effective.

This method seems grossly unfair in the context of this deal. With profit annuitants, represent about 20% of the fund and of the membership. Their interests are vitally affected by the proposed transfer, but there is no requirement for them to vote in favour as a separate group. Under Equitable Life's the 'one man 10 votes' system, any dissenting with profit annuitants will be hugely outvoted by other policyholders.

In the circumstances described above, with profit policyholders will have to rely upon the good offices of those who are supposed to be representing them, the Independent Actuary and the Financial Services Authority.

We have no reason to doubt the professional competence or integrity of Mr S J Sarjant FIA of Watson Wyatt Limited the Independent Actuary in respect of this transfer. However policyholders should be aware of the arrangements made with the Independent Actuary acting in the 2001 compromise. Under these, he owed no duty of care to policyholders, could not be sued by them and indeed was indemnified by the Equitable Life directors with policyholders' money. If these or similar terms apply to the Independent Actuary acting in the Prudential arrangement, then policyholders should be told about it. His instructions and terms of engagement are not included in the scheme documentation and it is not indicated that they will be made available for inspection.

As regards the Financial Services Authority, according to Equitable Life's web-site, it is not expected to report on the Prudential deal until 22nd November, that is about a month after policyholders have voted. They might reasonably ask how this reconciles with the FSA's strategic aim of 'Helping retail consumers achieve a fair deal'?

Regardless of the merits of the deal, the process of obtaining policyholders' consent is very unsatisfactory. Elderly with profit annuitants have been left inadequate time to take proper advice upon a deal that affects their income for the rest of their lives. The voting arrangements mean that the interests of those individuals will not be given proper weight. The Independent Actuary's instructions and terms of engagement will not be made available to those relying upon his judgement and bearing the cost of his fee. The Financial regulators' views on the transfer will not be available until a month after policyholders have voted.

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GENERAL

When the Society closed in December 2000 it comprised three separate businesses.

- With Profit Insurance – mostly building up pensions for those still working
- Conventional Annuities - providing fixed lifetime income for the retired
- Unit-Linked Investment - effectively sold to the Halifax (HBOS) in 2001.

The Society's finances were very weak and it was further hit by the stock market falls of 2001-2003. In spite of policyholders suffering policy value cuts of 16% in 2001 and of 10% in 2002 and agreeing to give up valuable legal rights in the 2001 compromise, Equitable Life's situation remains poor. In nautical terms, a substantial shoring up and bailing out exercise was carried out on the (not so) good ship 'Equitable'. This stopped it sinking, but did not make it seaworthy.

Financial weakness has meant that the Society has been obliged to remain invested in fixed-income securities. At the 30th June 2007 these represented about four fifths of its investment portfolio. This is why Equitable Life with profit policyholders have not benefited materially from the 80% rise in the Stock Market over the last 4½ years.

Many of Equitable Life's fixed income investments were acquired in 2001/2002 and their return to maturity can be predicted at about 4½% p.a. After deduction of expenses (at about 1% p.a.) this restricts its foreseeable annual bonus, arising from investments, to about 3½ % p.a.

Some of the obligation to remain invested in fixed-income securities derives from the Society's liability to pay annuities (lifetime pensions). A reduction in this effect was the main advantage to the Society in transferring its £4bn Conventional Annuity business to Canada Life earlier this year. However the Society still has about £1.8bn of liability to with-profit annuitants, which continues to restrict its ability to widen its investment base.

The present situation is unfavourable both for with profit annuitants and for other with profit investors (about £7.5bn).

With profit annuitants have seen their pensions reduced by a third or a half as result of Equitable Life's long-term problems and the stock market fall of 2001-2003. They have missed out on the recovery of 2003-2007 and are locked into an investment straight-jacket that can only deliver a return of about 3½% p.a. Many of their contracts were constructed upon the assumption of a much higher return. Someone whose annuity was set up on such a basis can expect his pension from Equitable to continue to decline for the rest of his life.

Prospects for other with profit investors are only a little better. Most of them are younger than with profit annuitants and invested their money in the expectation that it would accumulate in a broadly based fund to provide for their eventual old age. They have suffered policy value cuts and missed the upward swing of the stock market. Their prospects with Equitable Life are restricted by the limited investment spread dictated by the Society's poor financial state and its liability to the retired with profit annuitants.

The current proposal, that the Society's book of with profit annuity contracts be transferred to the Prudential, is designed to address these problems.

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WITH PROFIT 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 investments fare badly or annuitants live too long, then the insurer bears the cost.

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 by the insurance company. It is the annuitant, who suffers the cost if investments do badly.

The With-Profit annuitant also bears the cost if annuitants generally live longer than expected. Several times over the last two decades the Equitable Life with profit fund has been hit by the cost of increasing annuitant longevity and this has reduced annual bonuses.

THE PROPOSED TRANSACTION

The essence of the proposal is that the Prudential will take over responsibility for Equitable Life's with profit annuities. In return Equitable Life will transfer to Prudential a portfolio of investments worth an equivalent amount. The effective date of transfer is expected to be 31st December 2007.

Individual contract terms will not change. If an existing Equitable Life contract is for the life of a single individual or for the joint lives of a couple, then these provisions will remain after the transfer to the Prudential. If the existing contract guarantees a particular investment rate (the GIR), usually 3½% p.a. then this provision will remain after the transfer. Policyholders will not get a new policy from the Prudential with different provisions. The assumptions about future growth, which were made when the policy was originally taken out, will remain effective. The major changes that will affect policyholders are:

The Prudential will be responsible for administering the contract and making the payments.

Future (2008+) bonuses will be declared by the Prudential and will depend upon the performance of that company's with profit fund.

The Prudential is a quoted company, whose with profit fund assets were valued at £76bn at 31st December 2006. This is about three times the size of the Equitable Life fund at its peak in 1999. Its returns show free assets of 4.7 times its regulatory margin, a situation Equitable Life fell far short of.

WHAT ARE THE EXPECTED BENEFITS?

As far as with profit annuitants are concerned, the investment portfolio backing their annuities will have a potential for future growth, which cannot be achieved by the existing Equitable Life fixed-interest assets. This may well mean that future bonuses could exceed the current 3½% p.a. Depending upon the individual policy's original growth assumptions, this could mean that his/her pension will stop going down and could even go up.

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The departure of the elderly with profit annuity policyholders from Equitable Life will allow the directors greater freedom to invest for the benefit of the remaining (mostly younger) policyholders. Equitable Life will also be freed of the risk that annuitants will 'live too long'. These factors also improve the range of insurance companies who might be interested in acquiring what is left of Equitable Life upon terms reasonably favourable to the Society's policyholders.

As far as the Prudential is concerned, it will be acquiring a substantial (£1.8bn) slice of new business. 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. The Prudential expects to make a profit out of running the ex-Equitable Life policies for less than the 1% p.a. charge included in the agreement.

PRUDENTIAL PLC

Prudential plc is an international financial services company with a product range which extends from insurance, pensions and retail investments, to institutional fund management and property investments. Its portfolio of brands includes Prudential, M&G Investments, Jackson National Life Insurance Company and Prudential Corporation Asia. It claims more than 20 million customers (and policy holders and unit holders) worldwide.

It has significant operations in the UK, the US and Asia and employs 26,000 people worldwide. It is listed on the London and New York stock exchanges.

	Financial Statistics	
	Profit before Tax (2006 Year)	£3.2bn
	Shareholders' Equity (at 31 December 2006)	£5.5bn
	Market Capitalisation (Oct 2007)	£18.9bn
	Funds under management (at 31 December 2006)	£250.7bn

THE PRUDENTIAL WITH PROFIT FUND

The table below shows a comparison of the asset mix of the Prudential and Equitable funds:

Prudential With Profit Fund	31.12.04	31.12.05	31.12.06	Equitable 31.12.06
UK and Overseas Equities	48.5%	58.3%	53.0%	6.6%
Property	17.6%	15.3%	15.3%	8.7%
Alternative assets	2.1%	2.0%	2.4%	0.2%
	68.2%	75.6%	70.7%	15.5%
Fixed interest	28.6%	21.2%	25.4%	80.5%
Cash & Other Investments	3.2%	3.2%	3.9%	4.0%
	100.0%	100.0%	100.0%	100.0%

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The Prudential's with profit fund is invested upon traditional lines, with about 50% in equity shares, about 20% in other growth assets (mostly property) and about 30% in fixed interest investments and cash. This is very different from the existing Equitable Life portfolio, of which about 85% is invested in fixed interest and cash.

This investment profile gives the Prudential policyholders a much better chance of medium to long term growth than can be obtained with Equitable. However it does make the Prudential fund more volatile.

The Scheme documentation does not provide a history of the Prudential with profit investment returns or of bonus rates. This is regrettable since its fund is highly regarded in the industry and reckoned to have performed well during the falling markets of the early 2000s. Below is a summary of published bonus rates relating to its own with profit annuities.

Prudential With Profit Annuities	
Years since annuity started	Overall Average Bonus added
5 years	8.17%
10 years	6.32%
15 years	9.29%

These figures have to be read with some caution, since ex-Equitable Life policyholders will not be receiving equivalent policies and past performance is no guide to the future.

THE DETAILS

In principle, after the transfer, with profit annuities will be dealt with as set out below.

With profit annuities will retain the contractual structure set out in the original Equitable Life policy, but future bonuses will depend upon the performance of the Prudential's with profit investments and the bonuses which the Prudential declares.

The ex-Equitable Life policies will form part of a separate Prudential sub-fund (the 'Defined Charges Participating Sub Fund' or DCPSF). This is not a large sub-fund and the transferred policies will represent more than half of it.

The intention is that, as far as the transferred policies are concerned, they will be self funding over their lifetime, which is broadly that of the policyholders. Over this period, annuity payments to policyholders will have to be covered by the assets transferred from Equitable Life and the profits earned on them in the future by Prudential.

The DCPSF sub fund has no surplus assets. It is not, in itself, capable of withstanding the sort of risks that might arise in the future. For this reason the most serious effects of the risks described below will, at a price, be taken on by the main £70+bn Prudential with profit fund.

The first such risk is that the assets applicable to individual contracts will not be sufficient to pay the annuity guaranteed in that contract ('the guarantee risk'). The second risk is that with profit annuitants will live longer than expected ('the mortality risk'). Both these risks have previously been the responsibility of the Equitable Life with profit fund. The guarantee risk has limited the Society to mainly fixed interest investments. The mortality risk has reduced bonuses.

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As regards the guarantee risk, this will be taken on in full by the main Prudential with profit fund. The consideration will be an up-front premium payable by Equitable Life and an annual charge of not more than ½% p.a. payable by the DCPSF. As regards the mortality risk, Equitable Life will also pay the main Prudential with profit fund an up-front premium for taking this on. Its effect will be to limit the cost suffered or benefit enjoyed by the with profit annuities to ½% p.a. over the lifetime of the policies. This will provide better certainty of cost for with profit annuitants than could be provided by the DCPSF sub fund alone (or was previously provided by Equitable Life).

MECHANICS OF TRANSFER

The liability under the with profit annuity contracts and a portfolio of assets of equivalent value will pass from Equitable Life to the Prudential on the 'effective date', expected to be 31st December 2007. This will be done upon the basis of values estimated by the two companies at the time. Following the transfer, more accurate calculations will be made of the values of the policies and the assets. A subsequent balancing payment (either way) will be required to ensure that the amount of assets and liabilities transferred are in accordance with the agreement between the companies.

If it is eventually determined that the share of the Equitable Life assets due to with profit annuitants is in fact greater than the assets transferred plus the 'guarantee' and 'mortality' risk premiums, then the excess will be added to the value of their policies to enhance future benefits. This uplift is not expected to be large. If it transpires that there is in fact a deficit, then future benefits will be correspondingly reduced.

SMOOTHING

All future bonuses awarded by Prudential will be in non-guaranteed form, as Equitable Life's have been in recent years. Investment earnings on the backing assets will vary from year to year, but bonuses will be "smoothed" to try to ensure the objective of gradual, rather than erratic accrual. The aim will be to distribute all of the assets backing the transferred policies (after charges), in as fair a manner as possible over their remaining lifetime.

Prudential will also aim to maintain annual bonuses in the range of 0% to 11%. If stock markets fall in any year and there is a negative return on the fund, the smoothing account will normally be used to avoid declaring a negative bonus. Similarly, if the return on the fund in one year is higher than 11%, the bonus might be capped at that level.

If there is a really extreme (plus or minus) return in any year, or if there is a sustained series of good or bad returns, it may be necessary to announce a bonus outside the standard 0 per cent to 11 per cent range. When determining whether smoothing rules and limits for the transferring policies should be changed, Prudential will apply the same principles as it would for its other with-profits business.

The Prudential's main with profit fund is much better placed to cope with a negative smoothing balance, representing bonuses paid in excess of profits earned, than Equitable Life's fund ever was. The limiting factor is likely to be the need to balance the smoothing cost over the lifetime of the ex-Equitable Life policies. We would expect the Prudential to take a fairly conservative line in declaring bonuses on these policies.

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OTHER MATTERS

The Prudential's with profit fund has an inherited estate of assets that are not ear-marked to provide benefits for current policies. This may be the subject of a distribution to Prudential's policyholders and shareholders. Equitable Life with profit annuitants, whose policies are to be transferred to the Prudential will not be entitled to share in any such distribution.

The Parliamentary Ombudsman (Ann Abraham) has conducted an inquiry into the regulation of Equitable Life for an extended period ending in December 2001. A team of EMAG 'readers' has seen sections of her report on a confidential basis, but has as yet seen no findings, conclusions or recommendations. A draft version of her full report was sent to the Treasury and the FSA in January. Their response runs to more than 500 pages and is currently being considered by her. It is reasonable to assume from this response that she found maladministration leading to injustice and she may have recommended compensation.

The matter of compensation (if any) is essentially one for the PO and the Treasury. No doubt the directors of Equitable Life will press for the share of compensation relating to continuing policies to be paid to it for policyholders' benefit. We would expect the Prudential to press in a similar fashion for any compensation relating to with profit annuitants.

There are however many thousands of Equitable Life sufferers, who have en-cashed their policies or transferred their funds to other insurers. These represent well over half the original Equitable Life fund. EMAG has made it clear to the PO that a recommendation that compensation for their losses be paid to Equitable Life would be totally unacceptable. Firstly, those individuals have demonstrated their lack of confidence in the Society by moving their funds elsewhere, often at considerable cost. Secondly Equitable Life is not an appropriate investment vehicle. Thirdly it is in the course of being both broken up and run down. We anticipate that the PO will accept that compensation for ex Equitable Life policyholders should only be paid to them personally or to an insurance company of their choice.

RISKS FOR WITH PROFIT ANNUITANTS TRANSFERRING TO PRUDENTIAL

The Prudential is a large company, whose with profit fund has a substantial 'smoothing kitty', which may to some extent be used to protect with profit annuitants. The risks in this sense are considerably less than staying with the much smaller Equitable Life, with its inadequate smoothing kitty. Returning to nautical analogies, the 'Equitable' is small, damaged below the waterline and barely floating. The 'Prudential' is a much larger and more seaworthy vessel, better capable of weathering future storms.

It is now four and a half years since the stock market bottomed out in the spring of 2003 and started to go up. Historically this means the bull market may be approaching the dangerous 'mature' phase. Over the summer there have been considerable rumblings concerning sub-prime mortgages, resulting in a severe restriction of credit. There must be at least a better than average chance that the next major move in the stock market will be down. Having missed the last bull market, with profit annuitants may be joining an equity based fund just in time for the next bear one. They may indeed be jumping out the frying pan into the fire.

Typically policies issued before 1 July 1996 have the benefit of the 3½% income guarantee, which will continue and does provide partial protection. Later policyholders do not have this benefit.

In our previous report we suggested that Equitable Life could give policyholders the opportunity to convert their with profit annuities into conventional ones. In current

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circumstances, it is within the power of the Prudential to offer an asset backing with a smaller equity component more suitable for older policyholders. These options might well suit elderly policyholders and those with small funds, for whom the benefit of current certainty would outweigh the potential for future growth. We regret to note that no such options have been offered and are not contained in the scheme to transfer contracts to the Prudential.

CONTINUING EQUITABLE LIFE POLICYHOLDERS

With the departure of the with profit annuitants, continuing policyholders will no longer be at risk for their unexpected longevity and will gain the chance of better investment performance from a more appropriately invested fund. The remaining with profit business will also be more attractive to a wider range of insurance companies.

They will however still be at risk in respect of the ongoing costs of running what will have become a much smaller operation. The most serious ones are likely to be:

- a) The management agreement with Halifax, which has more than 3 years to run and an onerous penalty clause.
- b) The costs associated with the original Equitable Life staff pension scheme, which was not transferred to the Halifax with the staff and which has already given rise to additional costs.

CONCLUSIONS

It is now almost two years since talk of a break up of Equitable Life reached EMAG's ears. EMAG immediately made it very clear indeed that it would vigorously oppose any attempt to sell off the with profit annuity book to a vulture fund. Subsequently it has maintained pressure to ensure that any transfer is to a substantial and reputable company.

If with profit annuitants could produce a 'wish list' of companies that they would like to transfer to, the Prudential would be near the top of most lists. The Equitable Life directors are to be congratulated upon negotiating a transfer of the with profit annuity book to the Prudential, if not for the unfair process for obtaining policyholder consent.

Without access to the underlying documents, it is impossible to say whether the terms are fair to all concerned. Policyholders are reliant upon the fact that the transfer itself is an arms length deal between the Society and Prudential and upon the judgement of the Independent Actuary.

From our necessarily brief examination, it appears to us to be as good a deal as with profit annuitants are likely to get.

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