

The Equitable Life Assurance Society
v.
Ernst & Young
and
The Equitable Life Assurance Society
v.
R. Bowley and others

Supplementary Expert Report

Prepared By

M Arnold, FIA

11 January 2005



Section I - Introduction

1. I have been instructed to consider and, where appropriate, comment on the expert reports of Mr Dumbreck, dated 2nd November 2004, Mr McBride, dated 29th October 2004, Mr Whitworth, dated 27th October 2004, and Mr Creedon, dated 30th September 2004; and the witness statements of Mr Headdon, dated 18th November 2004, and Mr Bannon, dated 23rd December 2004.

E2-2.1
E3-1.54
E3-1.120
E2-1.167
W3-5.1
W2-284

2. The views which I set out below are directed principally towards the report of Mr Dumbreck. Where convenient I have at the same time addressed similar issues raised by the other actuarial experts, and have dealt with any outstanding issues in the final sections of this report. The topics which I consider in this report are as follows:

E2-2.1

Section II	Financial Reporting.	Page 5
Section III	GAR Provision.	Page 9
Section IV	Working or free capital.	Page 17
Section V	The impact of an additional GAR Provision.	Page 27
Section VI	Action that could have been taken in response to the additional GAR Provision.	Page 32
Section VII	Switching to the net premium valuation basis.	Page 34
Section VIII	Weakening the net premium valuation basis.	Page 51
Section IX	Release of margins from non-profit business.	Page 52
Section X	Selling assets.	Page 53
Section XI	Strict application of GAR terms.	Page 56


Milliman
Consultants and Actuaries

Section XII	Reducing the equity backing ratio.	Page 58
Section XIII	Limiting new business.	Page 64
Section XIV	Reducing annual bonuses.	Page 65
Section XV	Closing to new business.	Page 67
Section XVI	Hedging/reinsurance.	Page 68
Section XVII	Cutting policy growth rates: general considerations.	Page 69
Section XVIII	Cutting policy growth rates: Mr Dumbreck's comments on my approach.	Page 74
Section XIX	Value of new business: solvency capital.	Page 90
Section XX	Value of new business: sensitivity to volume.	Page 96
Section XXI	Value of new business: viable sale structure.	Page 100
Section XXII	Impact of viable sale structure on volume of new business.	Page 104
Section XXIII	Mr Dumbreck's estimates of the value of one year's new business.	Page 108
Section XXIV	Mr Creedon's report.	Page 109
Section XXV	Mr Whitworth's report.	Page 111
Section XXVI	Mr McBride's report.	Page 117
Section XXVII	Mr Headdon's second witness statement.	Page 122



Milliman

Consultants and Actuaries

Section XXVIII Mr Bannon's second witness statement. Page 128

Section XXIX Statement of truth and expert declaration. Page 129

3. In preparing this report:

- (i) I have tried to avoid repeating what I said in my first report (i.e., my report dated 27th May 2004, and corrected on 21st October 2004). I have **E1-1.41** tried to make this report as free-standing as possible, and I have therefore on occasions summarised what I said in my first report to reduce the need to cross-refer to my first report. However, except where I have indicated in this report that my view on any matter has changed from that stated in my first report, I stand by the views stated in my first report.
- (ii) I have concentrated on the matters which I consider to be most pertinent and, to the extent that I have not commented in this report on any matters contained in the expert reports or witness statements listed in paragraph 1 above, it should not be taken that I am in agreement with those matters.
- (iii) Except where I have noted that I have adopted a different definition, terms used in this report are as defined in my first report.

**Milliman**

Consultants and Actuaries

Section XIX - Value of new business: solvency capital

120. In paragraphs 5.12 to 5.23, Mr Dumbreck addresses the question of holding $\text{€}2-2.1$ solvency capital for new business. He makes the following points:

- (a) The provision of capital to cover the RMM in respect of the new business has a notional opportunity cost.
- (b) He states that no deductions for the cost of holding solvency capital have been made in the values of new business in the Components Report (referred to as the “CAA” in this report, for consistency with Mr Dumbreck’s report).
- (c) He comments that by the late 1990s capital was increasingly scarce for large insurers so that even proprietary companies with large with profits estates were, in many cases, seeking to attribute part of the value of those estates to shareholders so that making no adjustment for the cost of capital could result in decisions that were “*less than optimal in economic terms*” for such purchasers.
- (d) He makes various calculations of the cost of solvency capital.

121. In summary, I agree that the application of capital to cover the RMM has a notional cost, but I disagree with Mr Dumbreck’s argument that during the relevant periods there was a shortage of available capital throughout the UK financial services industry to acquire new life insurance business. On the contrary, the market for life insurance companies was quite buoyant as many non-insurance financial institutions were seeking to access the UK life insurance market, and, additionally, a number of potential purchasers of the Society already had insurance operations which had free assets in their with profits funds. I also note that Mr Cryan’s calculations have allowed for this notional cost in the selection of the discount rate used to establish the franchise value. Moreover, Mr Dumbreck acknowledges in Appendix K, paragraph 8, of $\text{€}2-2.1$



Milliman

Consultants and Actuaries

his report that he has not taken into account the working capital created over time by the new business itself; this could have been sufficient to cancel out the notional cost to the purchaser of covering the new business capital requirements.

122. I turn then to the detail of Mr Dumbreck's comments.
123. ***The provision of capital to cover the RMM in respect of the new business has a notional opportunity cost.***

I agree. However, such cost will vary from zero to the full cost of raising capital on the capital markets, depending on the particular circumstances of the acquirer. As I note in paragraph 126 below, the amount of capital generated internally from transacting with profits business would also influence this cost.

124. ***He states that no deductions for the cost of holding solvency capital have been made in the values of new business in the CAA.***

I agree that there is no allowance other than the increased risk discount rate.

125. ***He comments that by the late 1990s capital was increasingly scarce for large insurers so that even proprietary companies with large with profits estates were in many cases seeking to attribute part of the value of those estates to shareholders so that making no adjustment for the cost of capital could result in decisions that were "less than optimal in economic terms" for such purchasers.***

- (a) I disagree that by the late 1990s capital was becoming an increasingly scarce commodity for the life insurance industry, although I agree that life insurers were increasingly seeking to measure the capital requirements of business decisions and ensuring that an adequate return was expected on the capital committed, commensurate with the risks being accepted. Such assessments may have allowed explicitly for a



Milliman

Consultants and Actuaries

cost of capital arising from the loss of investment flexibility which the provider of that capital would suffer.

- (b) I do not recall precisely when the cost of capital began to be assessed routinely in the way Mr Dumbreck suggests, rather than as an adjustment to the risk discount rate, but to the best of my recollection it was not prior to 2000.
- (c) Mr Dumbreck also points out that “*proprietary companies with large profits estates were in many cases seeking to attribute part of the value of those estates to shareholders*”. I do not understand how this statement supports his assertion that there was a capital shortage since, in addition to acknowledging that there were companies with large estates, the attribution of such inherited estates to shareholders was a largely untried process at that time. In the absence of an attribution, it was desirable for companies to make the assets of the estate work harder, and the acquisition of enhanced sales capacity was one such option. I accept that after an attribution of estate, an acquirer would be more likely to seek to ensure that the cost of capital was adequately factored into the franchise value.

126. ***He makes various calculations of the cost of solvency capital.***

- (a) Mr Dumbreck assesses the effect of the cost of capital on the value of new business. In practice, the cost of capital depends on the source of the capital. His calculations are undertaken from the perspective of a acquirer required to allocate additional shareholder capital to support new business but, if the acquirer already had a with profits fund upon which new business could “depend”, then the cost of capital could be significantly lower. The extent to which the cost would be lower would be dependant on the financial position of the acquirer’s with profits fund and its ability to transact the envisaged volumes of business without



Milliman

Consultants and Actuaries

materially altering the financial position of that fund. Mr Dumbreck's calculations represent a worst case cost.

- (b) I have considered Mr Dumbreck's calculations. The approach he has adopted to place a cost on capital is appropriate for establishing the value of each year's new business taken in isolation. However, I agree with Mr Dumbreck (Appendix K, paragraph 8) that there is significant value to be derived in the longer term for an acquirer from the excess of capital which each year's new business will build up within the long term fund (in the form of unallocated surplus which will eventually be paid to policyholders as final bonus). The excess capital accumulating in this way may be used to cover the additional solvency requirements of the long term fund, thereby reducing the amount of capital which an acquirer would have to commit. This consequently reduces very significantly the total cost of capital when assessed over a long term business cycle.
- (c) At Appendix K, paragraph 4, of his report, Mr Dumbreck has ^{EQ-2.1} undertaken his calculations at 8.5% pa. It is not stated why the cost of capital supporting non-profit business has doubled from the amount stated in the CAA (and repeated in paragraph 5.18) of £2 million, and I have not been able to verify the increase. On a standalone basis and using the central discount rate of 7.5% pa (in conjunction with Mr Dumbreck's figures in Appendix K, paragraph 4), the cost of capital would reduce the value of new business by approximately £30 million, £30 million and £25 million (as at 1997, 1998 and 1999 respectively) for an acquirer who was unable to use an existing estate to shelter these costs.
- (d) I have extended Mr Dumbreck's calculations to estimate what effect would be obtained by an acquirer from utilising the excess capital generated by new business in the long term fund to cover solvency



Milliman

Consultants and Actuaries

requirements. Considering single premium with profits contracts (which is the largest business class), the capital required per £100 of premium, applying the bases set out in the CAA, is:

Table 12: Capital Requirement of a with profits contract, £

Year	1	2	3	4	5	6	7	8	9
Capital	4.1	4.3	4.5	4.7	4.9	5.1	5.4	3.4	-

Table 13: Capital generated by a with profits contract, £

Year	9	10	11	12	13	14	15	16	17	18
Capital	-0.6	-4.8	-9.2	-14.0	-19.1	-24.5	-30.2	-36.3	-42.7	-49.6

- (e) Table 12 (which is taken from Mr Dumbreck's calculations) shows the capital required to be made available by the acquirer over the first 10 years of a policy. It can be seen that by year 9, no external capital would be required in respect of the specimen policy described, and that state would continue through to the maturity of the policy. Table 13 shows the amount of excess capital generated in the with profits fund after 8 years (i.e., once the acquirer does not have to make capital available) from unallocated surplus relating to the specimen £100 policy considered. It can readily be seen that the amount of capital available grows rapidly from year 9 onwards. As a result, the acquirer would not need to make as much capital available since the excess capital generated in the with profits fund may be used to cover part or all of the solvency requirements of new business transacted thereafter.
- (f) To put this further into context, Mr Dumbreck has estimated that the capital required to support new business on a standalone basis could amount to approximately £1.3 billion at year 10 if the new business remained at the volumes and mix of 1999 (and assuming a capital requirement of 150% of the RMM). However, allowing for the excess capital generated within the long term as displayed in Table 13 would



reduce significantly the capital required to support new business transacted after year 10, and by year 15 there would be no need for an acquirer to make any additional external capital available.

- (g) If an acquirer was able to utilise fully the excess capital in this way, it would generate significant savings on new business issued after 8 years, since the cost of capital would become zero. For this reason, I believe that it is not reasonable to consider the cost of capital for each year's new business in isolation and that an acquirer would also consider the longer term benefits, which could offset the whole of the initial estimate of the cost of capital made by Mr Dumbreck.

- (h) For these reasons, I do not agree with Mr Dumbreck's approach to the calculation of the cost of solvency capital.

**Section XX - Value of new business: sensitivity to volume**

127. In paragraphs 4.24 to 4.35, Mr Dumbreck addresses the sensitivity of the ~~EA-2.1~~ valuation model to movements in new business volume. He makes the following points:

- (a) He calculates that the ratio of fixed to variable costs was approximately 70% to 30%.
- (b) He carries out calculations on the basis of this ratio to show the sensitivity of the value of new business to reductions or increases in volume, from which he concludes that in the short term the proportion of fixed expenses makes the profitability of future new business very sensitive to the volume of sales.
- (c) He says that it is unlikely to be possible to reduce fixed costs in proportion to falling business volume since economies of scale will be lost.

128. In summary, Mr Dumbreck's approach is premised on the assumption that any cost overrun arising from a reduction in new business would carry on indefinitely (and that therefore an allowance for this element should be made from the value of each year's new business itself). This is commercially unrealistic. Any purchaser would have recognised the prospect of a cost overrun in the event that the volume of new business fell away but would also have expected to reduce its cost base to accommodate the fall in business over a short period (of perhaps 3 years). For this reason, rather than reducing the value of new business (as Mr Dumbreck suggests) a purchaser would have made a deduction from the franchise value to cover the unavoidable overheads and the costs of reducing them to an appropriate level consistent with the volume of new business transacted. This would have represented a more realistic approach commercially than that suggested by Mr Dumbreck.

**Milliman**

Consultants and Actuaries

129. I address the detail of Mr Dumbreck's comments below.
130. *He calculates that the ratio of fixed to variable costs was approximately 70% to 30%.*

Mr Dumbreck assumes that 70% of the acquisition expenses are fixed expenses and only 30% are variable with the volume of new business transacted. This appears merely to be an assumption, and is not supported by any evidence. The position will vary from company to company, and I have not found it possible to verify Mr Dumbreck's figures in relation to the Society.

131. *He carries out calculations on the basis of this ratio to show the sensitivity of the value of new business to reductions or increases in volume, from which he concludes that in the short term the proportion of fixed expenses makes the profitability of future new business very sensitive to the volume of sales.*

Mr Dumbreck tests the sensitivity of the value of new business to the volume of new business transacted by determining the amount of acquisition expenses incurred by the Society that would not be covered by the expense margins derived from the new business written if the volume was at 125% or 75% of the levels actually transacted in each year. The sensitivity analysis discloses that slightly more than a 25% increase in new business was required to cover the acquisition cost over-run that was identified in the CAA in respect of 1999, and that if business halved then the over-run increased. I agree with Mr Dumbreck that an acquirer would be interested in identifying how the acquisition cost over-run would develop so that such costs could be managed efficiently post-acquisition. I have no material comments on the calculation he has undertaken for this analysis, although I do not accept the way that this information is then used to adjust the value of each year's new business for the purpose of the franchise value calculation, for the reasons given in paragraph 132 below.

**Milliman**

Consultants and Actuaries

132. *He says that it is unlikely to be possible to reduce fixed costs in proportion to falling business volume since economies of scale will be lost.*

- (a) I agree with Mr Dumbreck in his general comments that there would potentially be a reduction in the new business profit margin if the volume of new business was reduced in this way. However, I disagree with Mr Dumbreck that the result of this calculation would be taken directly to reduce the value of the reference year's new business. Although Mr Dumbreck classes the larger part of the acquisition expenses as fixed and I agree that these are costs which may not be removed readily or quickly, they are costs which could be managed down. I would expect that an acquirer would assess the costs of re-aligning the sales organisation with the reduced volume of sales implied. This restructuring cost would be offset against the franchise value rather than by reducing the value placed on each year's new business.
- (b) I also note that if profit margins suffered in this way as a result of significantly increased unit costs, then I would not expect that the Society's premium rebate mechanism would continue to operate. The Society's premium rebate mechanism was a means of distributing some of the expense surplus to holders of with profits or linked policies. The expense surplus for this purpose was the difference between the contractual policy charges and the assumed unit costs used in setting expense allowances for "Equitable Management Company" ("EMC") purposes. (This surplus was similar to, but not the same as, the profit which emerged on the EMC account which was shared (50%) with the Society's staff.) The value of new business established in the CAA was reduced by the premium rebate mechanism, since expense surplus was not assumed to accrue to the acquirer. The CAA estimated the value which an acquirer could generate by discontinuing rebates on new business at £28 million (at a 7.5% risk discount rate), which suggests that an acquirer could have had some leeway to re-price contracts but



Milliman

Consultants and Actuaries

still maintain competitive pricing. A reduction of the rebate allowance by 50% would be sufficient to offset the expense over-run identified by Mr Dumbreck.

**Section XXI - Value of new business: viable sale structure**

133. In paragraphs 5.36 to 5.49, Mr Dumbreck addresses the valuation of new ~~£2-2.1~~ business under the viable sale structure. He makes the following points:

- (a) He says, first, that the viable sale structure differs from a typical demutualisation in that the Society's business would be divided.
- (b) The viable sale structure is premised on the recognition that a full demutualisation and sale would not have been feasible in the light of the GAR problem.
- (c) The viable sale structure differs from a normal demutualisation and sale because it is alleged that the sale process would have started after the initial implementation of a programme of substantial cuts in Policy Values.
- (d) He expresses the view that the Society's financial position was vulnerable in certain scenarios and that potential purchasers would have been wary of any possible contamination of their ability to write new business which may have arisen from the financial position of the Society's existing with profits business.
- (e) He says that the likely amount of capital to be made available by a purchaser of the new business was approximately £1.3 billion over 10 years.
- (f) He says that the Society's name would have been tarnished, that there would have been a potential reputational risk to a purchaser getting involved at too early a stage since a purchaser might have been held partly to blame for any subsequent benefit reductions in the closed mutual, and that the existing policyholders would have been upset with the outcome of the Hyman litigation.



Milliman

Consultants and Actuaries

134. My comments on each of these points follow. As I state in paragraph 266 of my E1-1.1 first report, my comments are provided from the perspective of a consulting actuary advising the Society – the opposite perspective from that which Mr Dumbreck adopts which is that of a consulting actuary advising a prospective acquirer.

135. *He says, first, that the viable sale structure differs from a typical demutualisation in that the Society's business would be divided.*

The viable sale structure does not represent a demutualisation; quite the opposite, as the Society would continue as a free standing mutual. In this respect, the viable sale structure represents a different form of reorganisation for a mutual society from that typically implemented. However, I do not agree that the viable sale structure would divide the Society's business in a way which is materially different from the position which would apply in a "typical" demutualisation since it has frequently been the case that the demutualised fund has been closed to new business and all new business sold using the brand name of the mutual has actually been allocated to a different fund after demutualisation.

136. *The viable sale structure is premised on the recognition that a full demutualisation and sale would not have been feasible in the light of the GAR problem.*

I agree that the viable sale structure is premised on the recognition that the GAR problem would have deterred an acquirer from either acquiring an economic interest in the Society's with profits business or from transferring this business to its own long term fund and thereby running the risk that additional capital may have had to be allocated to support it in the future.

137. *The viable sale structure differs from a normal demutualisation and sale because it is alleged that the sale process would have started after the initial implementation of a programme of substantial cuts in Policy Values.*


Milliman

Consultants and Actuaries

Whilst it is true that the viable sale structure assumes that the sale process commences after the Society has commenced its programme of Policy Value management actions, the sale process is not intended to lead to demutualisation. Even if the sale process was intended to lead to a demutualisation, I do not know what a “normal demutualisation” would be since, in my experience, each demutualisation has been implemented in quite different circumstances and frequently this has been against a background of falling bonus rates and claim values for with profits contracts.

138. *He expresses the view that the Society’s financial position was vulnerable in certain scenarios and that potential purchasers would have been wary of any possible contamination of their ability to write new business which may have arisen from the financial position of the Society’s existing with profits business.*

As discussed in paragraph 136 above, the viable sale structure is premised on the vulnerability of the Society and the structure is intended to distance the Society from the acquirer as much as possible. New business would be written mainly in the acquirer’s long term fund, although as I outlined in Section VIII (2) of my first report, certain types of business may have had to continue to be E1-1.1 transacted in the Society. It is accepted that new business and existing business cannot be divorced from the circumstances of the Society and that the acquirer would probably reflect this risk in the calculation of the Society’s franchise value.

139. *He says that the likely amount of capital required to be made available by a purchaser of the new business was approximately £1.3 billion over 10 years.*

Mr Dumbreck’s calculation of the capital required over a 10 year period is E2-2.1 based on the assumption that the capital required to support each year’s new business will be provided by the acquirer either from fresh capital or from capital no longer required to support previously written business (i.e., existing

**Milliman**

Consultants and Actuaries

capital within a with profits fund of the acquirer as discussed in paragraph 121 above). He acknowledges that his approach ignores the capital which may be generated by the normal operation of with profits business and which may be used to support new business. As I describe in paragraph 126 above, the effect of this internally generated capital is significant. Allowing for the capital generated internally by with profits business (but otherwise applying Mr Dumbreck's assumptions) would reduce the capital requirement slightly from £1.3 billion to £1.2 billion at 10 years, but would remove completely the need for any external capital provided by the acquirer by year 16.

140. *He says that the Society's name would have been tarnished, that there would have been a potential reputational risk to a purchaser getting involved at too early a stage since a purchaser might have been held partly to blame for any subsequent benefit reductions in the closed mutual, and that that existing policyholders would have been upset with the outcome of the Hyman case.*

I agree that there would have been a risk that the Society's name could have been tarnished although the additional capital which the viable sale structure would have brought to the Society would have reduced the scale of the management actions required on growth rates and therefore reduced this risk.

**Section XXII - Impact of viable sale structure on volume of new business**

141. In paragraphs 5.50 to 5.69, Mr Dumbreck addresses the impact of the viable ~~E2-2.1~~ sale structure on the estimates of the likely volume of new business. He makes the following points:

- (a) He addresses the new business volumes by type of business.
- (b) He investigates the sources of new business.
- (c) He addresses the question of the sales force expertise.
- (d) He addresses the business climate.
- (e) He concludes that these points raise considerable doubt as to whether the volumes of one year's new business that I valued in my first report would actually have been achievable by a purchaser.

142. *He addresses the new business volumes by type of business.*

Mr Dumbreck identifies a number of broad categories of business transacted by the Society and suggests that an acquirer would raise doubts as to the ability to redirect new business under these headings to the acquirer's fund. I deal with these categories in turn.

- a) Mr Dumbreck notes that a large proportion of the Pension Annuity and Managed Pension business was likely to have been derived from maturing funds of the Society. Mr Dumbreck believes that redirecting this business would make investors aware of the open market option (which permits the purchase of the pension annuity from another insurer) and therefore they would seek the best rate, particularly as the Society's policyholders were "*relatively sophisticated*". Whilst I agree with Mr Dumbreck that much of the funds applied in these categories are, in effect, recycled, the risks of there being leakage to other insurers

**Milliman**

Consultants and Actuaries

are overstated. The Society's policyholders may well have been relatively sophisticated but the rate at which funds were recycled (approximately 75% as quoted by Mr Dumbreck at paragraph 5.57 of his report) suggests significant inertia on the part of the Society's policyholders. I would have expected that the Society's managed annuity contract would have been keenly priced as a result of the Society's expense structure. Consequently, I would have expected that many of the Society's policyholders would have accepted the new business terms offered by an acquirer.

- b) Mr Dumbreck notes that increments for existing and new members in group pension schemes could only be switched with difficulty as the decision to redirect lay not with the members, but with the Scheme Trustees. However, in the financial circumstances of the Society, many Trustees would be likely to find themselves in a difficult fiduciary position, particularly if the scheme's constituting documents required all of its investments to be held in the Society's insurance policies, which is a common feature of insured pension arrangements. Trustees would seek to balance the security of existing funds against the costs incurred on switching or redirecting contributions to another insurer. I would have expected that arrangements would be made to permit the use of the acquirer's contracts and that these would have been offered on similar terms to the Trustees. Consequently, whilst I agree that the position is more difficult to address, I do not believe that there would be a significant reduction in the level of new business assumed under this heading.
- c) Mr Dumbreck notes that DSS rebate business would not be attractive. I agree but, since this category was not included in the value of new business in the CAA (see paragraph 6.2), the point is irrelevant. However, I do note that whilst such business was being transacted, there was always a possibility that some of this business (and indeed possibly

**Milliman**

Consultants and Actuaries

other incremental business) would be redirected to the acquirer. This would enhance the value of the transaction for the acquirer.

- d) Mr Dumbreck suggests that policyholders may be disillusioned by the Society and therefore its advisers would not be able to effect a transfer of new business to the acquirer. This is a risk which would be run but since the proposition is that the acquirer would be able to offer terms based on the Society's low cost base but in a better capitalised fund, many of the Society's relatively sophisticated policyholders would be likely to recognise the continuing value for money in the replacement products offered by the acquirer.

143. *He investigates the sources of new business.*

This topic is largely outside the area upon which I have been asked to report. However, such a high level of direct sales by existing clients appears to me to be indicative of high level of inertia in the Society's client base and is one on which I would expect an acquirer to place a high degree of attention to ensure that the value of this feature could be maximised.

144. *He addresses the question of the sales force expertise.*

I do not agree that there would necessarily be a significant retraining exercise required to re-apply the sales force expertise. The Society's products were by and large very simple in design. The more difficult aspects of effecting sales would arise rather more from the generic technical advice required relating to pensions or other financial planning considerations. These skills are valuable and easily transferable. The main products sold by the sales force were with profits contracts but there has been no suggestion that these would not be available to the sales force after its disposal by the Society. In any event, whilst only 20 % of the Society's total new business related to non-profit and linked business, this represented 25% of its UK new business, and as Mr Dumbreck has noted, a significant proportion of the Society's new business was produced



Milliman

Consultants and Actuaries

independently of the sales force. I have not located any analysis to determine if direct sales or the sales force were primarily responsible for the sale of non-profit and linked new business.

145. *He addresses the business climate.*

Mr Dumbreck's principal observation on the business climate relates to the potential introduction of products with "capped" charges such as stakeholder pensions. I agree that an acquirer would be aware of this matter but given the Society's very low cost base, any acquirer would have viewed the Society as a means of introducing such capped products on a very cost effective basis.

146. *He concludes that these points raise considerable doubt as to whether the volumes of one year's new business I valued in my first report would actually have been achievable by a purchaser.*

This is a matter for the commercial judgement of the acquirer and not one which I considered in my first report. It is one which should be addressed by the investment banker retained by the Society.

**Milliman**

Consultants and Actuaries

Section XXIII - Mr Dumbreck's estimates of the value of one year's new business

147. In paragraphs 5.70 to 5.84, Mr Dumbreck estimates the value of one year's new ~~business~~ **£2-2.1** business and comments on the assumptions, basis and methodology underlying my calculation. Mr Dumbreck concludes that, on the basis of new business volumes 50% of those set out in the CAA, the value of new business before the cost of capital was £1 million for 1997, £2 million for 1998 and minus £2 million for 1999; and assuming new business volumes of 75% of those in the CAA the value of new business before cost of capital is £80 million for 1997, £21 million for 1998 and £15 million for 1999.
148. Mr Dumbreck adopts the stance of a consulting actuary advising a potential purchaser. In this regard, I agree that the nature of the advice which he would give would be different from the nature of the advice which I set out in Part VIII (2) of my first report. In particular, I agree that the sensitivity of the value of new business to volume changes and the cost of maintaining solvency capital are matters which he rightly should comment on in advising his principal on the development of the franchise value. I disagree with his approach to these matters, however, for the reasons set out in Sections XIX to XXII above. I consider the values which I placed on each year's new business in Part VIII (2) of my first report remain appropriate and a reasonable starting point from which to determine the franchise value.


Section XXVI – Mr McBride’s report
E3-1.54

165. A central thesis of Mr McBride’s report appears to be that the House of Lords was wrong in its understanding of how the policies issued by the Society should be interpreted. It seems to me that there is little purpose in my expressing my views at length on the basis of such an unreal assumption. To the extent that Mr McBride appears to focus on the difference between an annuity and a cash contract, I agree that there is a difference. However, on either basis, the Society was required to provide for the cost of the guarantee. Given Mr McBride’s strongly-stated view that the GAR contract was actually an annuity contract, I am surprised that he does not take the view that the appropriate GAR Provision should be derived from recognition of the value of that annuity.
166. In Sections B2 to B8 of his report, Mr McBride advances his view that the decision of the House of Lords in the Hyman litigation was wrong. He makes the following points: **E3-1.54**
- (a) The Society’s GAR policies differed from GAOR policies, in that the GAR policies did not offer a guaranteed cash sum as a principal benefit.
 - (b) The DTBP existed, but was dormant, until 1993.
 - (c) The House of Lords’ ruling was “inequitable” in ruling the DTBP impermissible, and “particularly inequitable” in not permitting ring-fencing.
 - (d) The DTBP was an exemplary model of actuarial equity, and the House of Lords ruling has put the life assurance actuarial clock back some 50 years.
167. I have dealt with point (a) in paragraph 165 above. All of the remaining points appear to relate to the impact of the House of Lords ruling on the inapplicability of the DTBP. I do not address these issues in my first report and do not believe



Milliman

Consultants and Actuaries

they are relevant to a consideration of the impact of the additional GAR Provision which I believe should have been held.

168. In Section B10 of his report, Mr McBride refers to the Society's approach to ~~E3-1.54~~ setting the GAR Provision in the Companies Act Accounts. Mr McBride appears to be endorsing that approach, although he does not actually say so. If that is what he is saying, I disagree, for the reasons set out in Sections II and III above.
169. In Section C, Mr McBride addresses the unusual features of the Society. I have ~~E3-1.54~~ dealt with these matters in Appendix 4 of my first report and having nothing to add to the points set out there.
170. In Section E of his report, Mr McBride deals with the allegations against ~~E3-1.54~~ Mr Ranson and Mr Headdon of breach of duty as Appointed Actuary. As I understand this section of his report, it again proceeds on the premise that the House of Lords was wrong. Mr McBride says that:
- (i) any GAR policyholder who thought that in times of low CAR he could have the full policy value applied on what he thought was a GAOR, had misinterpreted the policy;
 - (ii) from an actuarial perspective, Mr Ranson would have been in breach of duty in not proposing the DTBP in 1993; and
 - (iii) had he been the Society's Appointed Actuary, he could not have believed that the DTBP could be under serious legal question.
171. I do not consider these issues in my first report because I do not believe it is ~~E1-1.1~~ constructive to proceed on the basis that the House of Lords was wrong.
172. In Section F of his report, Mr McBride sets out his views on reserving and capital, and comments on my approach to the GAR Provision. He makes the following points:



Milliman

Consultants and Actuaries

- (a) There was nothing unsound about the Society's approach to provisioning, and the AGWP did not consider it unsound.
 - (b) The trading loss which the Society could have expected to suffer from the excess of GAR over asset shares, of £50 million, could have been financed through the bonus system without significant damage to the Society's standing in the insurance market.
 - (c) My approach to provisioning does not give a realistic view of the way in which benefits would ultimately be paid.
 - (d) Mr Headdon's approach to setting the GAR Provision was above the minimum required by the legislation, and I am wrong to say that it was inappropriate, inconsistent with legislation, or one which no competent Appointed Actuary would have agreed.
 - (e) My approach to provisioning is excessively prudent, not properly related to the legislative requirements, and significantly overstates the effect of the likely GAR commercial cost to the Society's business.
 - (f) He does not agree that future bonus prospects would have been substantially altered by the recognition of additional GAR Provision that I propose.
173. I give my views on the Society's approach to the GAR Provision in Sections II and III above. I disagree with Mr McBride's assertion that the additional GAR Provision would not have affected future bonus prospects for the reasons given in Sections XVII and XVIII above.
174. In Section G of his report, Mr McBride addresses reductions in bonuses. He E3-1.54 makes the following points:



Milliman

Consultants and Actuaries

- (a) The bonus cuts which I propose would have shocked policyholders and damaged new business prospects. The loss of new business could have been up to 50%.
 - (b) Bonus cuts would have been contrary to PRE.
 - (c) If bonus cuts had been made, and the Society won Hyman, the Society would not have recovered.
175. I have dealt with the PRE aspects of the growth rate recommendations that I suggest in Sections XVII and XVIII above. I recognise that the growth rate cuts that I suggest could have affected new business prospects but, managed appropriately, I do not believe they would have had the effect described by Mr McBride.
176. In Section H of his report, Mr McBride considers a sale of the Society. He E3-1.54 makes the following points:
- (a) He does not consider that a sale would have been necessary.
 - (b) The effect of the House of Lords' ruling was to unhorse equity, not solvency. Including an allowance for this effect before the ruling would have made it all but impossible for a purchaser to measure the value of the Society.
177. For the reasons I give in Part VIII (1) of my first report, I believe that raising fresh capital by means of selling certain of the assets of the Society should have been considered. I believe that the sale structure proposed by Mr Cryan in his expert report would have avoided the need to consider the effects of the House of Lords ruling on the value of the Society in any such sale process.
178. In Section I of his report, Mr McBride considers matters from the Appointed E3-1.54 Actuary's perspective. He makes the following points:

**Milliman**

Consultants and Actuaries

- (a) He would have advised the Board to continue with the DTBP in the face of policyholder complaints, and would have been unhappy about the Board sponsoring a court action to test the legality of the DTBP (although it would not have been his place to advise on legal matters).
 - (b) If there had been complaints about the DTBP he would have advised the Board to leave it to the complainants to take matters forward, and would have considered the risk of the DTBP not being supported in law, if challenged, as de minimis. He would have continued so to advise the Board after legal action had been commenced.
 - (c) He would not have advised the Board to take any precautions against the risk of the DTBP being declared unlawful.
 - (d) Whilst somewhat alarmed by the Court of Appeal ruling, he would have thought it too late to take any evasive action, and would have anticipated a positive outcome in the House of Lords.
 - (e) On reading the House of Lords' judgment, he would have felt that the scientific basis of actuarial management had been undermined to an extent that he would not have known on what basis to continue in practice.
179. I have not considered these matters as I do not believe they are relevant to a consideration of the need to establish an appropriate GAR Provision and the consequences of doing so.



Milliman

Consultants and Actuaries

Section XXIX - Statement of truth and expert declaration

191. I understand that my duty in providing written reports and giving evidence is to help the Court, and that this duty overrides any obligation to the party to whom I am engaged or the person who has paid or is liable to pay me. I have complied and will continue to comply with my duty.
192. I confirm that insofar as the facts stated in my report are within my own knowledge I have made clear which they are and I believe them to be true, and that the opinions I have expressed represent my true and complete professional opinion.
193. I have endeavoured to include in my report those matters, of which I have knowledge or of which I have been made aware, that might adversely affect the validity of my opinion. I have clearly stated any qualifications to my opinion.
194. I have shown the sources of all information I have used.
195. I have not without forming an independent view included or excluded anything which has been suggested to me by others including my instructing lawyers.
196. I will notify those instructing me immediately and confirm in writing if for any reason my existing report requires correction or qualification.
197. I understand that:
- (a) My report, subject to any corrections before swearing as to its correctness, will form the evidence to be given under oath or affirmation;
 - (b) I may be cross-examined on my report by a lawyer assisted by an expert; and
 - (c) I am likely to be the subject of public adverse criticism by the judge if the Court concludes that I have not taken reasonable care in trying to meet the standards set out above.



Milliman

Consultants and Actuaries

197. I confirm that I have not entered into any arrangement where the amount or payment of my fees is in any way dependent on the outcome of the case.



M Arnold
Fellow of the Institute of Actuaries

11 January 2005