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Actuaries Institute

The End of the Equitable

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Equitable Life Assurance Society

- The oldest life insurer in the UK (1762)
- A mutual society
- A pioneer in actuarial practice
- 1990s - In the top 10 UK insurers (£33 billion)
- Closed to new business in 2000
- Policyholder benefits slashed
- Now in run-off (£6 billion)

Analysis of Events

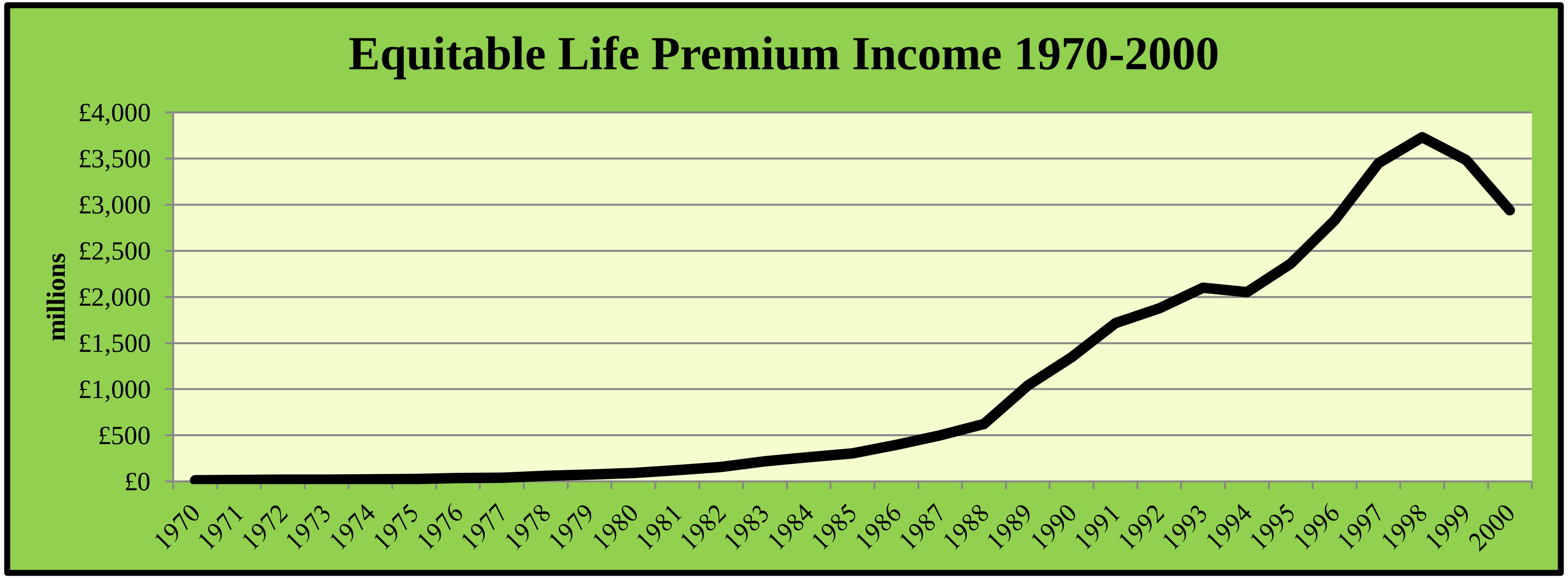
- List of Reports at http://www.equitablelifemembers.org.uk/
  - *Equitable Life Assurance Society v Hyman (House of Lords)*
  - Baird Report (FSA)
  - Penrose Report (House of Commons)
  - Warren and Glick/Snowden Legal Opinions (Mis-selling)
  - Institute of Actuaries Corley Report (Professional Standards)
  - Institute of Actuaries Disciplinary Panel
  - Parliamentary Ombudsman #2 – *A Decade of Regulatory Failure*

This paper

- A (relatively) concise summary of events
  - In context: actuarial thought & practice
  - Lessons for actuarial profession
    - Note: Damage to reputation of profession
  - Lessons for prudential supervisors
    - Light touch?
    - Regulatory capture?
- Feedback please?

Section 1 : Background

- 1970s: small & conservative, losing business
- Growth Objectives – very successful (until 2000)



Product

- Recurrent Single Premium (capital guaranteed)
- “Managed Fund” + smoothing (bonuses)
- At retirement
  - Cash benefit
  - Buy annuity at current market rate
  - Buy annuity at guaranteed rate (GAR / GAO)

Reasons for Success?

- Low expenses?
- No commission?
- Good customer service?

- Bonus rates

Outline

- 1. The Estate
- 2. Bonuses
- 3. Valuation / Financial Reporting
- 4. Guaranteed Annuity Rates
- 5. Aftermath
- 6. Corporate Governance / ERM

“With Profits Without Mystery”

- 1989 Institute / 1990 Faculty presentation
- Roy Ranson (AA) & Chris Headdon
- Principles for running a with-profits fund
- A mixed reaction

1. The Estate

The Estate

- How much is enough?

- Inherited Estates
- Redington’s “Flock & Sheep”
- For a Mutual? Withholding benefits [health funds?]

The Estate

Large Estate

- Security / Solvency
- Smoothing
- Investment flexibility
- Funds for New Business

Minimal Estate

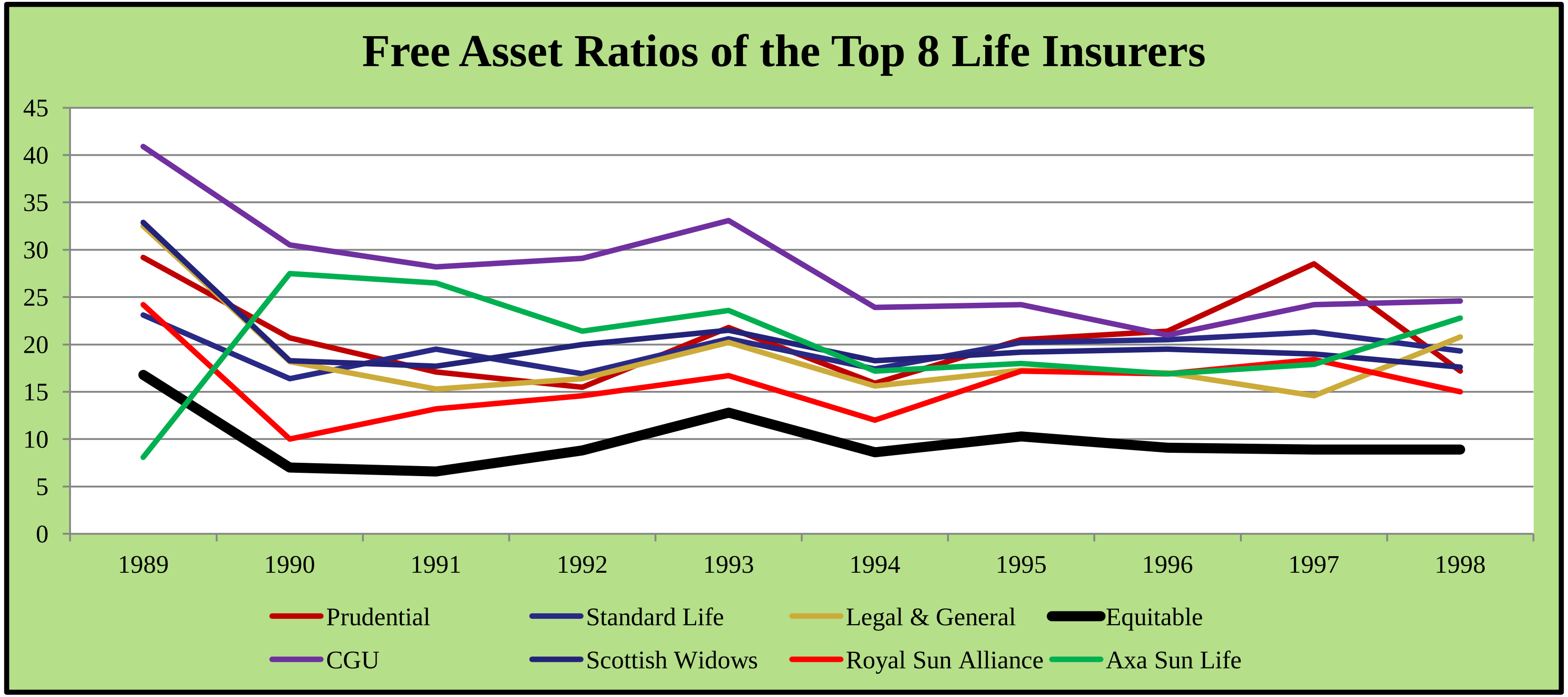
- “Full and Fair” distributions
- “More equitable” between generations
- Higher Bonuses
  - Principles?
  - or
  - Pragmatism?

Making a Virtue of Necessity?

- *There is, however, a more fundamental issue to be addressed…it must be asked why strength is of itself a desirable feature. Clearly there needs to be an adequate level of strength or an office is at risk of having the DTI intervening in its affairs. However, beyond such a level of adequacy* ***it is difficult to see the merit of strength as an end in itself****. One must ask for whom the strength is being built up. There is an argument that* ***a high level of strength could indicate a failure to achieve a full value return to policyholders….***

- *Criticism of* ***"so-called strength"***

Equitable's Free Assets Ratio



2. Bonuses

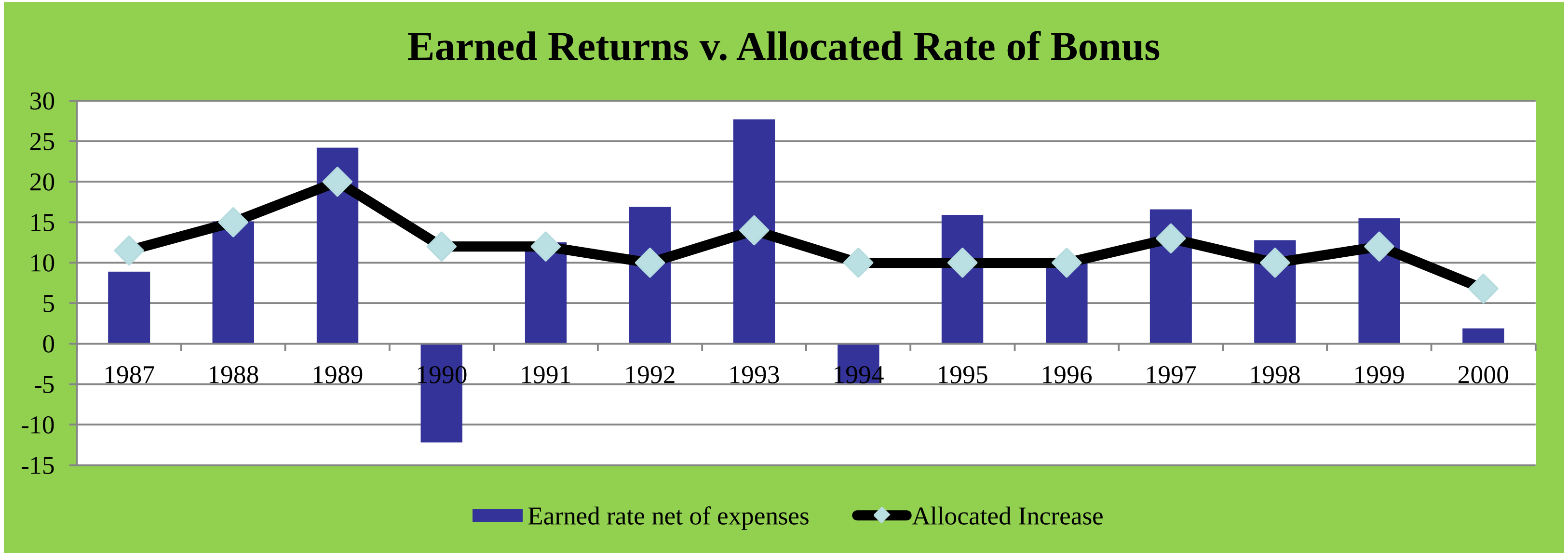
Bonuses : Theory

- Theory (*WPWM*)
  - Equity = Benefits should reflect “Asset Share”
  - If no Estate: benefits must fluctuate up and down in line with experience
  - Subject to some smoothing (unspecified)

- ?? Smoothing -> Risk of over-crediting

Bonuses : In Practice

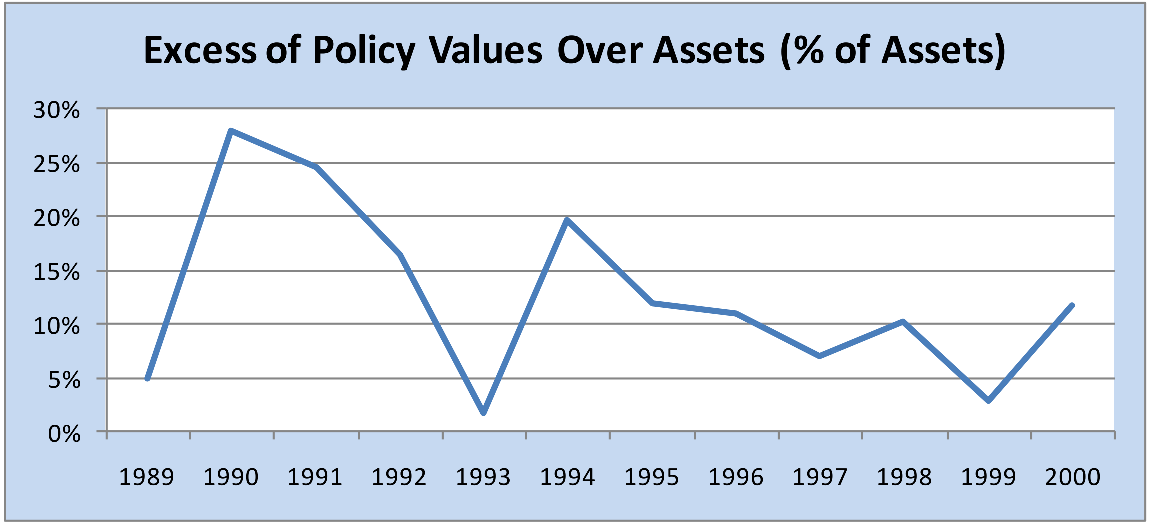
- First test of the theory in 1990….
- Failed (market forces)



- **Effective Smoothing**
  - Sometimes Benefits > Asset Share
  - Sometimes Benefits < Asset Share

- **The Equitable**
- **Ineffective Smoothing**

- Average 113%



Impact of Over-crediting

- Total overpayments = £900m (1990-2000)
- Result 1: Weakening financial strength
- Result 2: Intergenerational inequity
  - *"We need to get in-force policy values down to say 90-95% of asset shares and keep them there for a number of years to reduce the accumulated excess claim figures; that may be uncomfortable given our openness about actual and allocated returns."*

Mr Ranson: Professional Misconduct

"The Investigating Committee claim that Mr Ranson failed to put any detailed monetary analysis before the Board in relation to asset shares, the ongoing relationship between total policy values and the value of the fund, the cumulative cost of overpayment of claims on maturing policies and the likely adverse effect on the future values of policies belonging to remaining policyholders and the likely time to bring the fund back into balance."

Competitors

- Other life offices were over-crediting too.
  - For the same reason
  - -> improve rank in performance tables

- But maybe they could afford it (?)
- Hmmm… regulatory concerns

Bonus Strategy

- **Traditional Reversionary Bonus**
  - Once declared, guaranteed
  - Reserves are required
  - Disciplined release of surplus over time
- **Terminal Bonuses (1960s)**
  - Can go up or down at any time
  - Not guaranteed; No reserves required
  - Undisciplined

Early Warnings on Terminal Bonus

- CSS Lyon (1987)

Terminal Bonus as a Percentage of Total	Number of life offices
Not exceeding 20%	5
Over 20% up to 33.3%	6
Over 33.3% up to 42.9%	18
Over 42.9% up to 50%	17
Over 50% up to 55.6%	9
Over 55.6% up to 60%	2
Total	57

- Increasing importance
- Risk of Over-crediting
  - Bonus war?
- Too much Discretion
  - Lack of transparency
  - Risk of inequity

Example: Application of Discretion

- The Equitable **(and other offices)** gave “special treatment” (i.e. extra bonuses) for policies which were maturing at specified durations
  - -> the ones which were reported in performance league tables
  - -> a cheap marketing tactic (esp. if few maturities)
- Problem:
  - -> inequitable
  - -> created unrealistic PREs

Policyholder Reasonable Expectations

- Theoretically…Actuary must consider PRE
  - Legislation
  - Professional Standards
- In Practice
  - PRE was undefined
  - The Equitable’s Actuary did not pay enough attention
    - Absolute discretion?
    - Leading to downfall of the Equitable

3. Valuation & Financial Reporting

UK Tradition: Freedom With Publicity

- Importance of complete and accurate disclosure

- Financial Advisors used this information
  - Temptation to fudge the figures for marketing purposes
  - Easy: Lots of loopholes in the regulatory solvency standards

- The Equitable's Reported Solvency was Overstated for several years before it closed

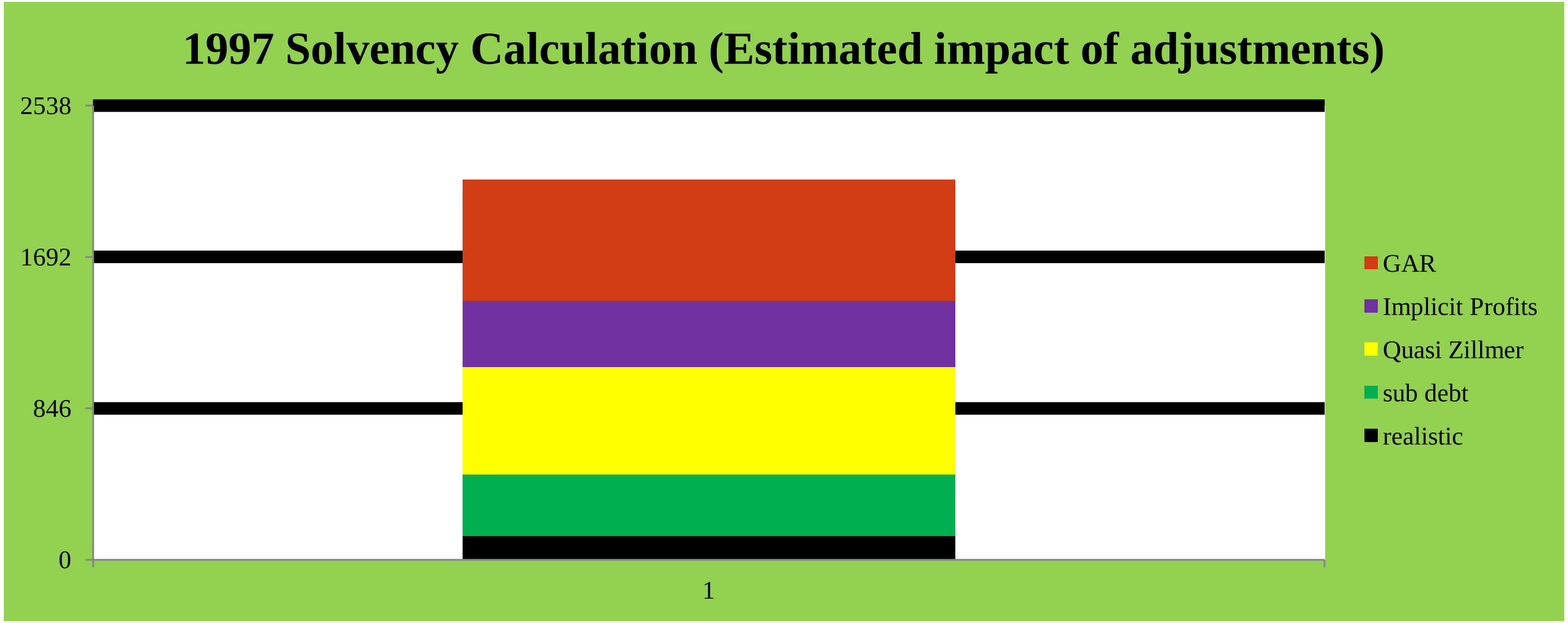
Mr. Ranson: Dual Roles

- Appointed Actuary - Responsible for prudent valuation
- CEO Responsibility - Responsible for meeting growth goals
- Roy Ranson was both AA and CEO from 1991 to 1997
  - Conflict of roles
  - Overrode objections of regulators, auditors, Board members
  - Recommended: never again

Liability Valuation Weaknesses

- 1. Back to Front Valuations
- 2. Professional Judgement?
- 3. Quasi-Zillmerisation
- 4. Subordinated Debt (for a Mutual?)
- 5. Implicit Profits Item
- 6. Reserving for Guarantees
- 7. Financial Reinsurance

Estimated 1997 Solvency Adjustments



Implicit Profits Item

- Regulations require valuation on a prudent basis including conservative margins
  - Regulator carefully checks compliance

- But if the life office wants to report higher solvency…
  - Apply for permission to count E[future profits] as an implicit asset
  - Theoretically this “releases” the conservative margins
  - Actuary must certify the amount of E[future profits]
  - No rules for calculation, no checking : regulatory rubber stamp

Implicit Profits for Equitable

- Release of conservative margins in valuation?
  - Equitable's margins were already very thin (at best)
- Actuary's certification of E[future profits]?
  - No evidence that any calculations were done
- Future Profits Implicit Item of $1,000m in 2000 accounts?
  - The Equitable was already closed to new business and future profits did not seem very likely

Future Profits Implicit Item

- Many other life offices used future profits items
- Completely routine / accepted
- After Equitable's collapse
  - No longer allowed
  - Was this an Actuarial blind spot?

Regulatory Capture?

- The weaker the Equitable became….
- ….the more “adjustments” were used to “improve” reported solvency.

- Regulator is always keen to “save” a weak insurer
  - Regulatory forbearance
  - Strongly criticised later (P.O.)

- “Late joiners” lawsuits ? (settled in confidence)

Lord Penrose Comments

- *The Society's solvency position was bolstered over the period by the consistent (and frequently acknowledged) adoption of the weakest valuation basis, plus a series of particular* ***valuation practices of dubious actuarial merit*** *(the interest rate differential, financial reinsurance and the quasi-zillmer adjustment) and other financial adjustments and supports (increasing reliance on future profits and subordinated debt) that sought to* ***anticipate future returns.***

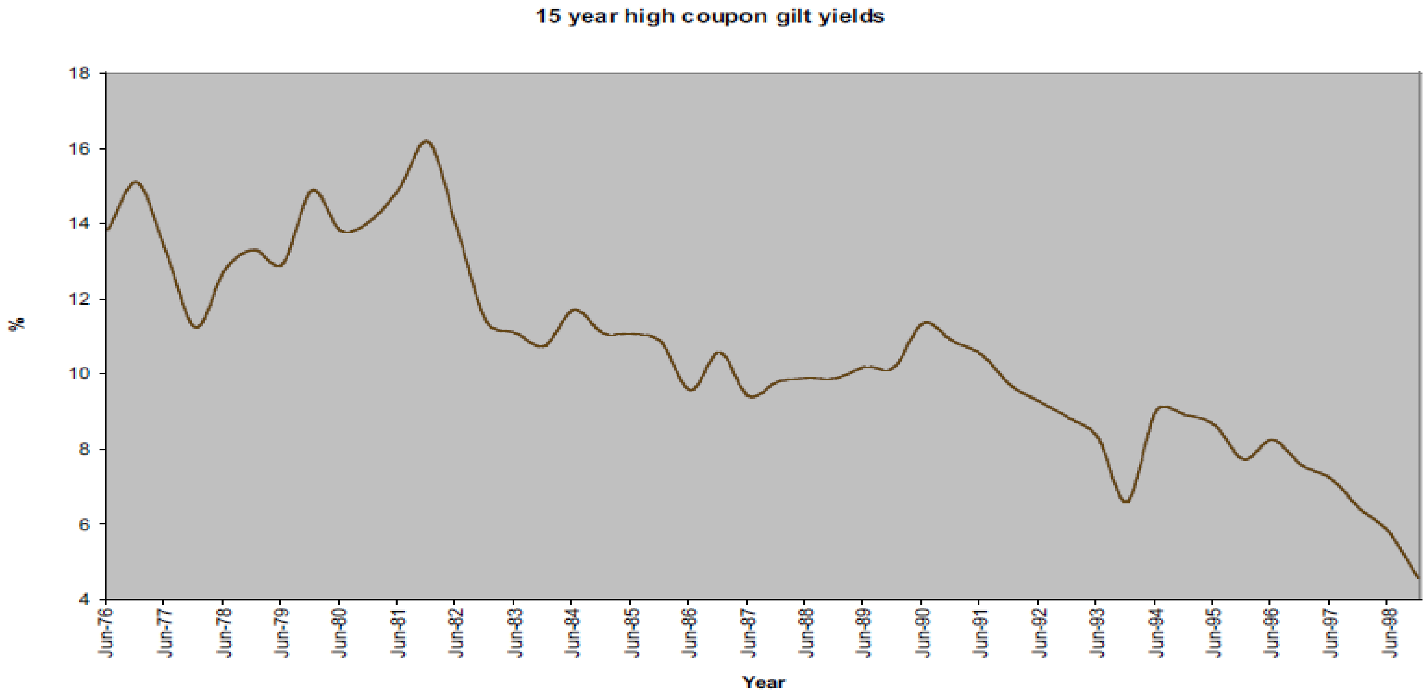
- *The regulators also failed to give sufficient consideration to the fact that* ***a number of the various measures used to bolster the Society's solvency position were predicated on the emergence of future surplus.***

4. Guaranteed Annuity Rates (GARs)

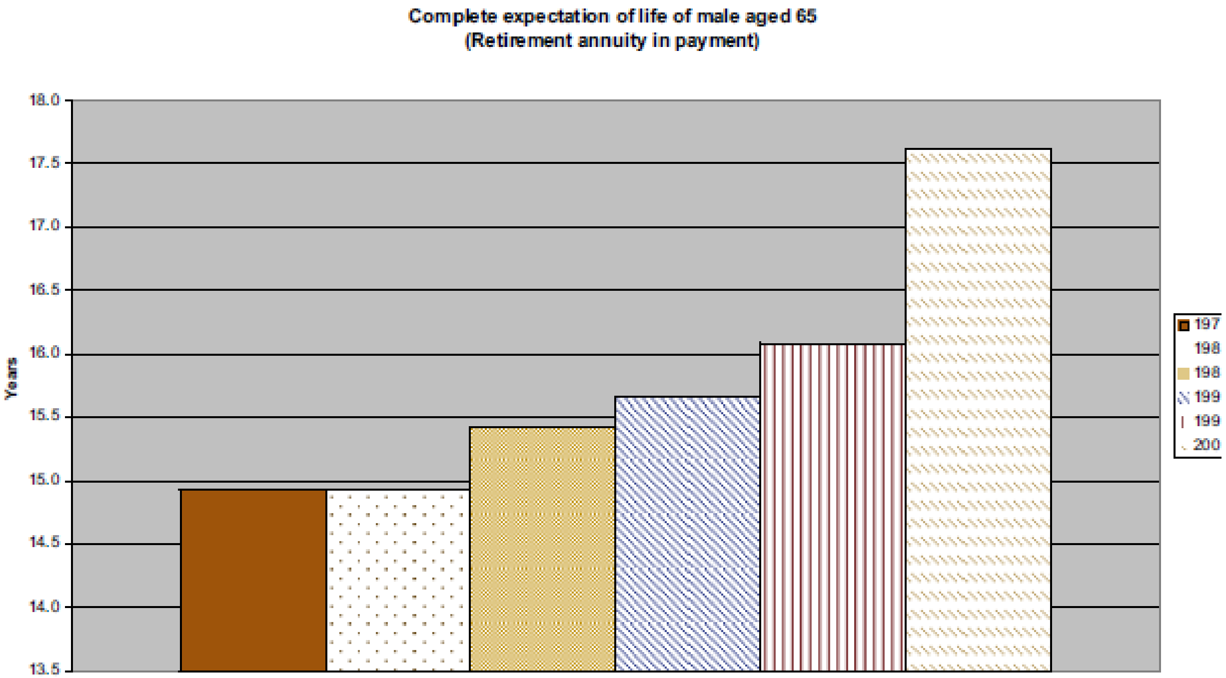
4. Guaranteed Annuity Options

- Equitable sold policies with GARs from 1957 to 1988
- Guarantees were improved in 1975
- At the time of sale, the guaranteed rates were “out-of-the-money”
  - Guaranteed Rate << Market Annuity Rate
  - No charges for the guarantee
  - No reserves held for the guarantee

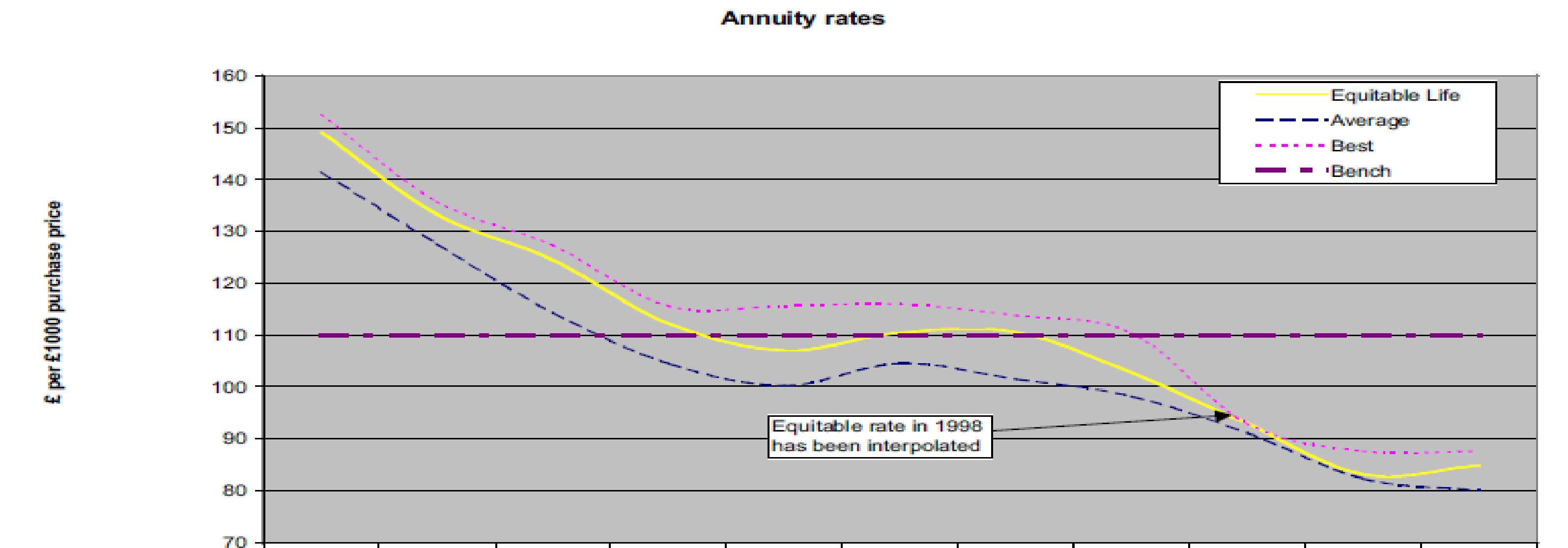
Interest Rate Trends (Baird Appendix)



Mortality Rate Trends (Baird appendix)



Annuity Rate Trends (Baird appendix)



	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Equitable Life	149	133	124	112	107	110	111	103	93	83	85
Average	142	128	114	105	100	105	102	98	91	82	80
Best	152	136	127	116	116	116	114	110	93	88	88
Bench	Representative guaranteed rate										

Equitable's Dilemma

- *Q. How to pay for guarantees which were in the money?*

- <u>Option 1:</u> Reduce bonuses for all
  - Non-GAR policyholders subsidise GARs
    - Inequitable – not asset share

- <u>Option 2:</u> Reduce bonus for GARs only
  - Effectively make the guarantee worthless (*)
    - Breach PRE – not in line with marketing

Differential Terminal Bonus Policy

	Policyholder A - No Option	Policyholder B = With Option
Cash Fund including declared reversionary bonus	£80,000	£80,000
Terminal Bonus	£20,000	£10,000 (reduced)
Total	£100,000	£90,000
Annuity Rate	9% (current)	10% (guaranteed)
Pension per annum	9,000	9,000

Disclosure Issues

- From 1993-1997, the Equitable…
  - \- did not tell people that they were eligible for GAR
  - \- did not tell people that there bonuses were reduced to offset the guarantee cost
  - \- rather vague comment in annual bonus statement
- *"…clients might feel that we have been a bit underhand in 'sneaking in' this change"*
- *Q. Did they think no one would notice?*
- 1998 – newspapers print "Equitable: Not so Equitable" stories

Other Life Offices?

- Many other life offices also sold GARs
  - (Not as many or as valuable as the Equitable)
  - Some also neglected to tell their policyholders that they were eligible for GAR
  - Some also reduced terminal bonuses to offset GAR cost

Reserving Issues

- *Q. Should an insurer hold reserves for* ***out-of-the money*** *options / guarantees which are built in to its policies?*

- A. Yes. Out of the money options still have a value.
- But apparently very few UK insurers did so.

Reserving Issues

- *Q. Should an insurer hold reserves for* ***in-the-money*** *options / guarantees which are built in to its policies?*
- A. Yes.
- But a LOT of UK insurers were under-reserved.
  - Institute of Actuaries Working Party 1997
- The Equitable held NO RESERVES for the guarantees
  - WP: "*could be viewed as unsound because no explicit provision is made for an explicit guarantee*'. (?!?)

Reserving Issues

- Suppose a GAR is in the money.
- <u>Example</u>: Policyholder can take either
  - Accumulated cash fund £80,000 OR
  - GAR annuity worth £90,000

- *Q. What liability should be shown in the valuation?*
- Equitable under-reserved by £675 million in 1997

Reserving Issues

- In 1998 regulators <u>insisted</u> the Equitable should set aside correct reserves for GARs
- Approx £1.5 billion
  - → They did not have the money
  - -> "*Barely solvent*" (actually, probably not)
  - → Arranged financial reinsurance deal
  - -> Kept declaring bonuses (if not, "commercial suicide")

Side Letter

- FSA was doubtful about Fin Re
  - Especially the cancellation clause
  - Equitable amended the contract
  - FSA approved (shouldn’t have)
- Equitable provided a “side letter” re cancellation
- Did not tell the FSA about the side letter

Mr Headdon: professional misconduct

- *The system of the Appointed Actuary is heavily dependent upon open disclosure and dialogue with the Regulator and any material departure from complete openness and candour brings discredit to the profession.*

Mr Nash: professional misconduct

- During 1999 there was bad PR for the Equitable. Mr Nash (CEO) sent a reassuring letter to policyholders

  - *"….The speculation regarding financial difficulties and costs to be borne by with-profits policyholders is therefore unfounded. Your Society remains, and will continue to remain, financially secure."*

  - Institute of Actuaries: This was misleading.
  - Professional misconduct: admonished.

Test Case for DTBP:Equitable v Hyman

Equitable

- Absolute discretion
- Equitable (asset share definition)
- Terminal Bonus never guaranteed

House of Lords

- Policyholder reasonable expectations
- You gave a guarantee + illustrations -> PRE
- This must be taken into account when exercising discretion
- DTBP not allowed

5. Aftermath

Consequences for the Equitable

- Cost of House of Lords decision: £1.5 billion
- Up for sale within days
- Capital injection?
- After due diligence : no buyers
  - Valuation problems
  - Unlimited liabilities for GARs
- When the last potential buyer quit
  - -> Closed to New Business

Consequences for the Policyholders

- No bonuses for 7 months in 2000
- Benefits cut by ~15% in 2001
- Compromise Scheme in 2001
  - Eliminated GARs
  - Eliminated mis-selling cases

Risk Management / ERM

- 1. Dual Role eliminated
- 2. Better professional standards
  - E.g. valuation of guarantees
  - E.g. managing PRE
- 3. Internal ERM of all actuarial functions
  - Products, bonuses, valuation
- 4. External review / audit of Liability Valuation

Question for Discussion

- **Whistle-blowing & Actuarial Discipline**
- *"It would improve the public image of the profession if it were seen to accept responsibility for direct intervention where it was thought that the administration of life funds was likely to threaten the legitimate interests of policyholders."*