# The End of the Equitable

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# Introduction

*The Society for Equitable Assurance on Lives and Survivorship* was established in 1762, and it was the first really successful life insurer in England. In many ways, the actuaries of the Equitable were pioneers in the development of actuarial theory and practice. For hundreds of years, the Equitable met the needs of its policyholders. However, this illustrious history came to an end in December 2000, when the Equitable closed its doors to new business. In the following years, the Equitable's policyholders suffered sharp reductions in their benefits. The Society is now in run-off, with steadily diminishing assets. Sadly, the collapse of the Equitable has caused great financial distress to many thousands of its policyholders.

What went wrong?

The events surrounding the demise of the Equitable have already been documented in dozens of judgements and reports. There are thousands of pages of detailed information, covering a number of rather complex issues. Each report has a different purpose and emphasis, e.g. some look at the deficiencies in actuarial management; some look at regulatory short-comings; some are designed to assess the legal situation in relation to compensation. The aim of this paper is to produce a (relatively) concise summary of the key events, focussing on issues which will be of greatest interest to members of the actuarial profession.

The main sources for this paper are:

- The Baird Report for the Financial Services Authority[1]
- The Institute of Actuaries Disciplinary Tribunal[2]
- The Glick/Snowden Joint Opinion on Mis-selling Liabilities, produced for the Financial Services Authority
- The Penrose Report to the House of Commons[3]
- The Parliamentary Ombudsman's second report*: Equitable Life: A Decade of Regulatory Failure*
- *With Profit Without Mystery,* by RH Ranson and CP Headdon, as presented to the Institute of Actuaries (1989) and the Faculty of Actuaries (1990)

Where possible, I have tried to set the story into the context of actuarial thought at that time, as revealed in professional publications (e.g. papers presented to the Institute and Faculty of Actuaries)

[1] "Report of the Financial Services Authority on the Review of the Regulation of the Equitable Life Assurance Society from 1 January 1999 to 8 December 2000, which Her Majesty's Government is submitting as evidence to the Enquiry Conducted by Lord Penrose, 16 October 2001.

[2] *In the Matter of the Equitable Life Assurance Society and the Hearing of the Disciplinary Charges Brought by the Investigating Committee Against Roy Henry Ranson CBE MA FIA, Christopher Paul Headdon MA FIA and Alan Nash, MSc FIA before the Panel of the Disciplinary Tribunal*, available at on the website of the Institute of Actuaries at www.actuaries.org.uk

[3] Report of the Equitable Life Inquiry, Return to an Order of the Honourable House of Commons dated 8 March 2004

Many of the above-mentioned reports lay blame on the insurer's management. I take no pleasure in criticising the decisions made by the actuaries involved in this case. The collapse of the Equitable has been tragic for many of those involved, ending the careers of highly respected members of our profession. These men held positions of great responsibility, and often had to make decisions under difficult circumstances. With the benefit of hindsight, we can see that they made grave mistakes; but at the time, these decisions did not seem so unreasonable.

If the Equitable's actuaries made mistakes, they were certainly not alone. Many other life offices were following similar policies, and there is no doubt that several other insurers were also in a rather precarious state by the end of the 1990s.

The regulators must also share the blame. The regulators were well aware of many of the problems at the Equitable. The investigations into the collapse of the Equitable revealed a number of deficiencies in the accounting standards, actuarial standards, legislation, and prudential regulation of insurers. The Parliamentary Ombudsman's second report was entitled *Equitable Life: a Decade of Regulatory Failure.* Although the management of the Equitable bears the prime responsibility for the collapse, regulatory failure was a contributory cause.

This paper has the following sections

Section 1 – Background

Section 2 – The Estate

Section 3 – Bonuses

Section 4 – Valuations

Section 5- Guaranteed Annuity Rates

Section 6 – Aftermath of the House of Lords Decision

Section 7 – Corporate Governance and Risk Management

# SECTION 1 Background

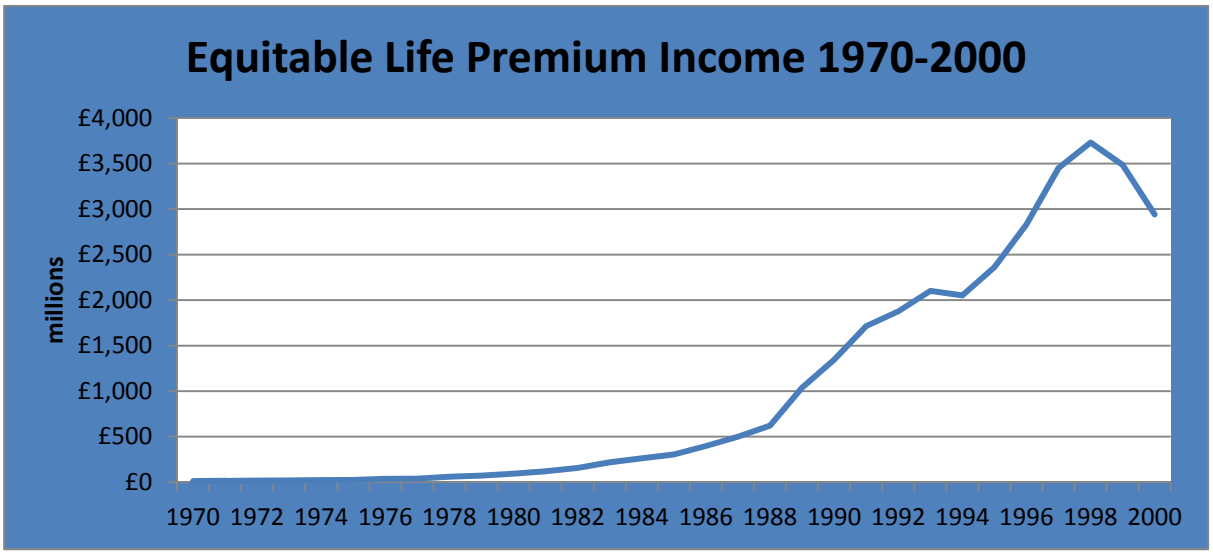
## *1.1 The Equitable*

In the early 1970s, the Equitable was a small, conservative life office. Most of its premium income came from just one source, the Federated Superannuation Scheme for Universities (FSSU). However, due to legislative and tax changes, this source of business was expected to gradually decline over the next decade. In order to replace the FSSU business, the Equitable adopted a new strategy. The objective was growth. New branches were set up; the sales force was enlarged; marketing efforts were stepped up. The management began to focus on growth, and the Society's public statements repeatedly referred to the desirability of more growth.[4]

Lord Penrose commented that

> *"Initially aimed at replacing FSSU business, sustained growth became an independent objective pursued with something approaching missionary zeal and with the conviction that the Society had a unique range of products and offered a unique level of service to its target clientele of high value policyholders. The pursuit of growth came to characterise marketing policy from the mid 1960s until the late 1990s."*[5]

Over the next thirty years, this strategy was very successful. The Equitable grew much more rapidly than its competitors, and eventually became one of the largest insurers in the UK. The following graph shows the growth in premium income over this period.[6] At the end of 2000, the Equitable was closed to new business, so premium income is now virtually nil.




[4] Penrose 3.10-3.12
[5] Penrose 3.4
[6] The data is taken from the Appendix to the Penrose report

## *1.2 Product*

The target market was pension business for high-net-worth individuals. The main product sold was a recurrent single premium policy. The policyholders would pay an initial single premium. This would be invested in a mixed portfolio of fixed interest, property, and equities. The policy values would increase each year, by the addition of bonuses. The rate of bonus would be determined by the directors of the Society, after considering the advice of the Appointed Actuary.

At retirement, the policyholders had a choice. They could take their Policy Value in cash and buy an annuity from another life insurer; or they could use their Policy Value to buy an annuity from the Equitable. In order to make this product more attractive, the Equitable provided guaranteed annuity rates. The marketing material explained how this worked: for example if the accumulated Policy Value was £100,000, and the guaranteed annuity rate was 10, then the policyholder would be entitled to a minimum guaranteed annuity of £10,000 per annum. Of course, if the then-current market-based annuity rates produced higher benefits, then the market-based annuity rates would be applied instead.

When these policies were first sold, the guarantee was out-of-the-money: that is, the guaranteed annuity was much less than the market-based annuity. Over time, as interest rates fell and mortality rates improved, these guarantees became more valuable. Recognising the risk, the Equitable stopped selling guaranteed rate annuities in 1988.

Many other life offices had offered similar guarantees. By the mid 1990s, these guarantees were in-the-money. Many of these insurers were facing substantial losses; several were facing solvency problems; but the Equitable was the most vulnerable. The Equitable had had a very large exposure – about 116,000 GAR policies, with very flexible conditions which made the options more valuable. And the Equitable had also been pursuing growth-oriented strategies which had steadily eroded the Society's financial strength over many years.

The guaranteed annuity rates caused solvency problems for the Equitable. The Equitable responded by adopting a controversial bonus policy which undermined the value of the guarantees. The decline in new business in 1999/2000 (shown in the graph above) is the result of adverse publicity about the guaranteed annuity rates.

Problems arising from the Guaranteed Annuity Rate policies are described in more detail in section 5.

## *1.3Growth Oriented Strategies*

As noted above, the Equitable grew very rapidly for many years. How was such rapid growth achieved? The Equitable did have some real advantages over its competitors. The Society was well-known for having very low expense ratios – about half of the industry average. The Society prided itself on providing good customer service. The Society did not pay commissions to financial advisors

– and this won plaudits from consumer groups and financial advisors. And, as noted above, the Equitable offered attractive guarantees (better than those offered by many other life offices).[7]

Many customers were also attracted by the Equitable's excellent bonus rates. The financial press regularly published comparisons of the bonus rates and/or maturity values offered by all the major life insurers, and these comparisons influenced sales. The Equitable's marketing strategy relied on staying at or near the top of the table. As we shall see, over the 1980s and 1990s, marketing considerations began to have a greater and greater influence on the Actuary's bonus recommendations.

## *1.4 With Profits Without Mystery*

We can gain some insight into the Equitable's strategy by reading *With Profits Without Mystery,* a paper which was presented to the Institute of Actuaries in 1989[8]. The authors were RH Ranson and CP Headdon. At the time, Mr Ranson was the Appointed Actuary of the Equitable; Mr Headdon was a senior actuary in the Society (he later became the Appointed Actuary, when Mr Ranson retired in 1997). The authors set out to describe the Equitable's approach to managing its with-profits fund.

The authors argued that the with-profit policyholders should be regarded as members of a managed fund. The policyholders pay premiums, which are invested in a fund. Expenses are deducted. The cost of providing life cover is deducted. Investment income is added to the fund. In a mutual insurer, profits and losses from other types of business (e.g. non profit policies) are added or deducted. The benefits ultimately payable would reflect the value of the assets in the fund attributable to each policy, i.e. the policyholder's asset share.

This sounds quite similar to a unit-linked fund. However, the actuaries pointed out that with-profits policies were different because:

- The with-profits policies include some guaranteed minimum benefits (the sum insured plus declared reversionary bonuses).
- The life office would smooth out investment returns, to provide greater stability in the amount of benefits. So the benefit payable might be above or below the asset share, after allowing for smoothing.[9]
- In a unit linked fund, the amount of profit is determined by investment performance; in a with-profits fund, the policyholder may share in other sources of profit or loss, including mortality, expenses, surrenders, etc.

This description of with-profits business was not controversial – similar ideas had been expressed by several other actuaries and were generally accepted. However, the rest of the WPWM paper was

[7] The Equitable strengthened its guarantees in 1975 and the higher guarantees applied to policies written between 1975 and 1988. The guarantees were improved in order to attract more business. Policies written between 1975 and 1988 were the major source of problems for the Equitable in the 1990s. Policies written before 1975 had much lower guarantees. Penrose 2.15

[8] The same paper was presented to the Faculty of Actuaries in 1990. The Institute and Faculty both published the discussions of this paper, which provides comments by other actuaries as to the strengths and weaknesses of the proposed strategies.

[9] With Profits Without Mystery, section 2.1

quite controversial, since the authors recommended an approach which was significantly different from traditional actuarial practice. The proposed approach had implications for reserving, bonus distribution, product design, valuation, and expense management.

Section 2 discusses Reserving; Section 3 discusses Bonus Policy; and Section 4 discusses Valuation Issues.

# SECTION 2: The Estate

Traditionally, life insurers would maintain a large estate. The estate may be loosely defined as the surplus of assets over the value of guaranteed liabilities[10]. For a mutual insurer, the existence of a large estate had advantages:

- The estate provided greater security for the policyholders, since money would be available to cover any unexpected contingencies;
- The estate enabled greater stability in the declaration of bonus rates from year to year, since the estate could be used to smooth out fluctuations in profits from year to year;
- Hence the estate allowed greater flexibility in investment policy, i.e. an asset allocation with a higher proportionate investment in volatile asset classes such as equities; and
- The estate provided a source of funding for the expansion of the business

The Equitable's own history illustrated the advantages of maintaining a large estate. During the 1960s, the Equitable had changed its asset allocation to include a higher proportion of equities. This had been a profitable decision, resulting in significant capital gains on the shares. The management had adopted a very conservative approach to these profits. Assets were shown in the balance sheet at book value, and only 10% of the capital gains were appropriated to revenue each year. The rest was held in off-balance-sheet reserves. By the end of 1972, the Society had off balance sheet reserves of £52 million, relative to the fund value £143 million. This was consistent with the Board's policy of maintaining ample reserves to provide greater security to policyholders.[11]

In 1973/74, the share markets crashed in 1973/74. The Board could have reduced bonus rates to reflect this fall in profitability; many other life offices did so[12]. But the Equitable was seeking growth, and a fall in bonuses would have had a negative impact on new business. So the Board decided to use the off-balance-sheet reserves to supplement revenue and hence maintain a high bonus rate. The Board also approved a weakening of the valuation basis, to release "hidden reserves". By the end of 1976, the Equitable had used up most of its reserves and it was in a weak financial position – but it had maintained bonuses and maintained new business growth in line with objectives. Over the next few years, as markets recovered, the Board once more began to build up reserves.

Although this traditional approach to the estate had some advantages, it also had some disadvantages. The estate was built up by withholding some profits from the policyholders, i.e. by

[10] Note that there is no standard definition of the estate, and different actuaries use different definitions.
[11] Penrose 3.2
[12] See Bonus Distribution with High Equity Backing, by Kennedy, Froggatt. Hodge. And King, JIA 103 NO 1, June 1976

reducing bonus rates in profitable years. Those who were policyholders while the estate was accumulating would receive benefits which were less than their notional asset share (as calculated using the managed fund approach). This was particularly likely to affect rapidly-growing life offices: under traditional actuarial theory, the estate should grow in line with the overall increase in the insurer's liabilities.

There was some controversy about the appropriate size of the estate. During the 1980s, some actuaries had expressed the view that life offices were too conservative – they had built up excessive estates, far more than necessary to provide an adequate level of security for the policyholders. A very eminent actuary, Frank Redington, had presented a paper to the Faculty of Actuaries which suggested that life offices placed too much emphasis on "protecting the flock" while overlooking the needs of the individual "sheep".[13]

In 1989, the Equitable's actuaries argued that a large estate was unnecessary and indeed undesirable. Under the managed fund approach, policyholders should receive the "full value" of the fund's profits. In *WPWM*, they said

> *Those policyholders participate in a pooled fund and, when they leave, should take 'full value' from the fund. The fund is continually open to new members. In particular, we do not believe in the concept of an 'estate' in the sense of a body of assets passed from generation to generation and which belongs to no-one.*

According to traditional actuarial thinking, a large estate was a sign of financial strength. But the authors rejected this thinking – they argued that "financial strength" was not necessary (above the level required to satisfy the regulator). Indeed, policyholders should avoid life offices which had large estates, since this was probably caused by under-distribution or poor growth rates.

> *The office which consolidates more of its earnings will have smaller 'free reserves', other things being equal. Similarly, the office whose business is of shorter duration will have smaller free reserves than a more mature office. It is by no means clear why an item affected by such factors should be regarded as a suitable measure of strength from the viewpoint of a new policyholder. Indeed, a high level of such 'strength' could indicate features such as poor growth or under-distribution to policyholders which would make the suitability of choosing such an office doubtful. It could also be argued that with profits policyholders expect bonuses to be declared at the highest levels sensible. Comparisons of 'strength' based on measures of unconsolidated earnings run directly contrary to that expectation.*
>
> *There is, however, a more fundamental issue to be addressed. Even if a better measure of strength could be made, 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.*

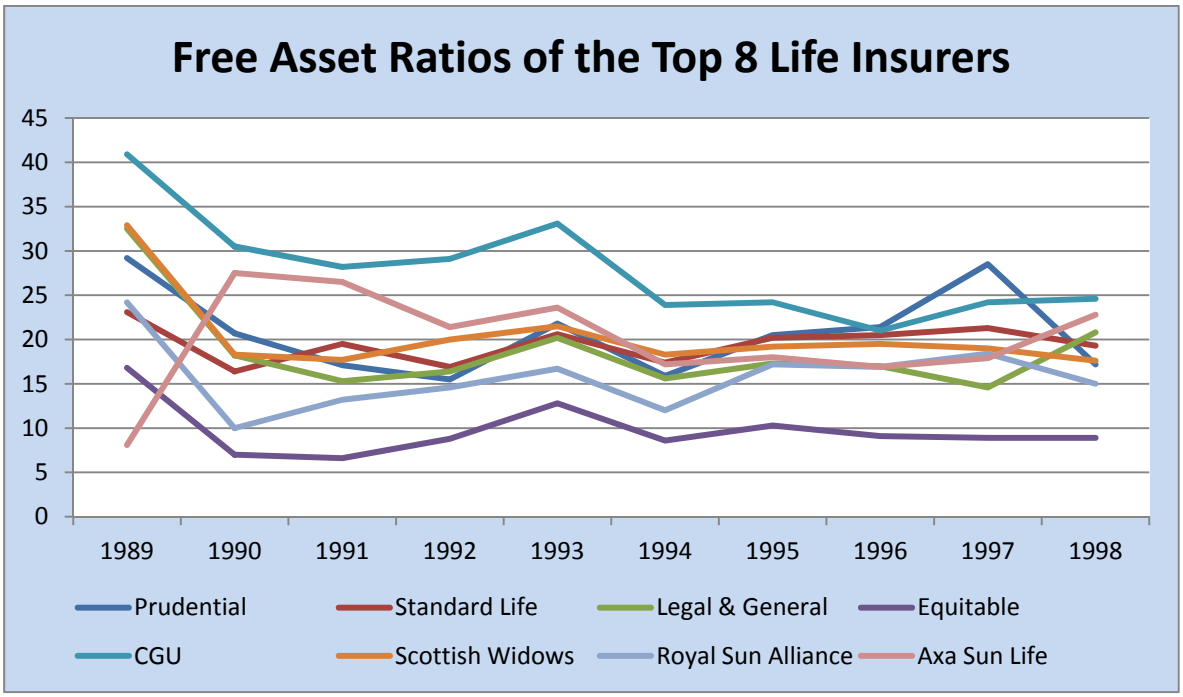
[13] The Flock and the Sheep and Other Essays, FM Redington, Transactions of the Faculty of Actuaries, 1981-1983, Volume 38, page 356-406

> *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 although, of course, such strength does add to the office's freedom of manoeuvre. Whether that is desirable or not is a matter of judgement.*

*With Profits Without Mystery* was presented to both the Institute of Actuaries (in 1989) and the Faculty of Actuaries (in 1990). The response was mixed. Although some actuaries applauded the proposed managed fund approach, there were others who expressed reservations. In the discussion of the paper, several actuaries stressed the well-established advantages of maintaining a large estate.

However, their arguments clearly did not convince the Equitable's actuaries.

During the 1980s and 1990s, the Equitable's Board accepted the strategy which had been recommended by their actuaries. The Equitable's free asset ratio was consistently lower than its competitors'.[14]




According to information distributed by the Equitable's management, this apparent weakness was a deliberate policy, adopted as a matter of principle: the Society was morally opposed to "unnecessary" increases in the free asset ratio; the Society was opposed to holding back profits; it was opposed to inequitable intergenerational transfers of profit.

But perhaps this was simply "making a virtue out of necessity". The Equitable's management was strongly motivated to grow. In order to grow, it was necessary to declare high reversionary bonuses, which would reduce the free assets ratio. And rapid growth would also create new business strains,

[14] The Parliamentary Ombudsman provided the following definitions. Free Assets = the excess of assets and implicit items over the liabilities. Free asset ratio = the excess of fee assets and implicit items of an insurance company over the required minimum margin, expressed as a percentage of total assets determined within the regulatory returns.

which would also tend to depress the free assets ratio. So the Equitable's new principles for the equitable treatment of policyholders very conveniently tallied with the Equitable's growth-oriented business strategy.

The *WPWM* strategy was presented to the Equitable's policyholders in various missives, e.g. *Dear Policyholder* Letters such as the following dated February 1989:

> *"Although the with-profits system contains within it an essential element of smoothing, nevertheless the Society's practice is to limit that to evening out peaks and troughs and unduly sharp changes from year to year. Specifically, we do not set out to build up excessive free reserves which some describe as 'strength'. This could only be done by deliberately, or worse still accidentally, withholding part of the return to members for the benefit of their successors. What is important is that there should be sufficient strength to avoid any unplanned constraints on investment freedom or growth in business, whilst still giving a "full value" return to existing members."*

The above statement acknowledges the desirability of smoothing benefits, maintaining investment flexibility, and financing new business. All of these require a significant level of reserves, on top of the statutory minimum solvency reserves – but the Equitable did not intend to hold large reserves. With the benefit of hindsight, we can that it would be difficult meet all of these objectives.

Under the Companies Act 1982, insurers are required to meet minimum solvency standards. [15] If an authorised insurer failed to meet the solvency standards, the regulator could intervene – e.g. by preventing the insurer from selling new business. The comparatively low level of free assets meant that the Equitable was more likely to face solvency problems if there were any unexpected shocks. In *WPWM*, Ranson and Headdon argued that these solvency issues could be addressed by adopting a suitable bonus system, and a more flexible valuation basis.

# SECTION 3: BONUSES

## *3.1 Asset Shares and Smoothing*

In *With Profits Without Mystery*, the Equitable's actuaries proposed new approaches for distribution of surplus.

If a with-profit fund is treated as a managed fund, then benefits for with-profit policies should roughly match the policyholder's asset share, subject to smoothing. This was in line with well-accepted actuarial principles. But there were differences of opinion about the appropriate level of smoothing.

Ranson and Headdon were rather equivocal about this issue. The main thrust of their paper was to give "full distribution" of returns, without holding anything back. This implied that the benefits

[15] The solvency standards are described in the Baird Report

would closely match asset shares, without much smoothing. Ranson and Headdon argued that bonuses should be allowed to fluctuate up and down; policyholders should not expect consistency.

> *"Future bonus additions will naturally depend on the return which can be earned on the managed fund. It follows that any discussion of future bonus prospects, in the sense of ability or otherwise to maintain current rates of bonus, is irrelevant*."[16]

Ranson also commented that

> *"We have no expectations that next year's bonus will necessarily have any relationship to this year's bonus; of course it is convenient if it does, but if it is doesn't then it won't – a brave thing to say!.. We regard current bonus levels as reflecting history and nothing more. They imply nothing for the future."*[17]

Of course smoothing would be possible for an insurer which kept a large estate. But the Equitable had no intention of doing so. The Society told the policyholders that

> *"...if part of the surplus otherwise available for distribution to policyholders was set aside for future emergencies, this would have been at the expense of policyholders whose policies were in force or maturing when those surpluses arose. In the view of the Board, such an approach would have been inconsistent with full and fair distribution."*[18]

Since there were no reserves set aside for emergencies, this naturally meant that it would be more difficult to smooth bonuses when an emergency did arise. In WPWM, Ranson and Headdon said that:

> *"The industry has done itself no favours by allowing the view to develop that in some way life office bonus rates are largely unconnected with general investment conditions and that there are 'massive reserve' always available to meet any deficiency in returns."*[19]

All of this suggests that the Equitable's bonuses would fluctuate over time.

On the other hand, Ranson and Headdon also argued in favour of smoothing.

> *"The question of averaging and smoothing of performance is crucial. We believe that policyholders selecting the with-profits approach do not wish to see the volatility of returns which characterizes linked business; that is, the mutual insurance of the investment risk, which, as noted above, is a key feature of the business, should apply not just to reversionary bonuses but also to total proceeds.…There are a number of ways in which such smoothing and averaging can be achieved…"*

In the discussion of WPWM, several actuaries raised the issue of smoothing. The authors of WPWM advocated "full distribution", but also claimed that fluctuations in investment performance would be

[16] WPWM 4.2.3
[17] Faculty discussion on WPWM
[18] Baird 3.11.2 ff
[19] With Profits Without Mystery, section 4.2.3

smoothed. JA Jenkins pointed out that these two objectives were inconsistent. He recommended greater disclosure of the smoothing methodology.

Another actuary, PNS Clark, warned that an undisciplined approach to smoothing could lead to insolvency.

> *I believe that the implication the authors draw from this is that, ignoring smoothing, the sum of individual asset shares for individual policies equals the market value of the fund. This means that smoothing must be a totally balanced concept, that any over-payment to one group of policyholders must be equally and oppositely balanced by an under-payment to another group. Failure to achieve this must inevitably lead to insolvency in the long run if the rest of the theory is left intact.*

These remarks were prescient. Over the next decade, the Equitable failed to develop a sound smoothing policy; the benefits paid consistently exceeded the policyholders' asset share; and this dragged the Equitable to the edge of insolvency.

In WPWM, Ranson and Headdon had suggested that bonuses should vary up and down in line with investment returns. But in practice, they found it impossible to follow this strategy.

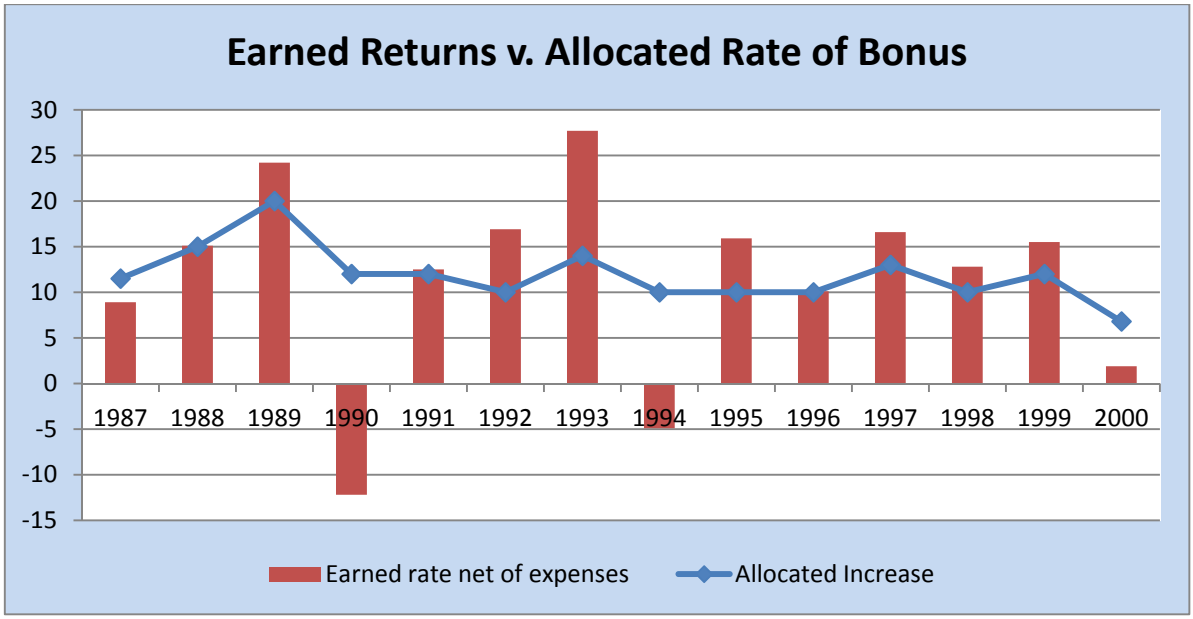
- In 1990, the year after WPWM was published, there was a severe market downturn. But the Equitable maintained high bonus rates.

- In 1994, there was another severe market downturn. But the Equitable maintained high bonus rates.

- In 2000, there were very poor investment returns. But the Equitable paid bonuses at rates which were higher than the earned rates (despite the fact that the Society was in severe financial difficulties by this stage).

The following graph shows the relationship between the earned rate of return and the bonus rates which were actually declared, from 1987 to 2000[20].

[20] This graph is similar to the one presented n chapter 6 of the Penrose report, and is based on the data given in the Appendix to that report.



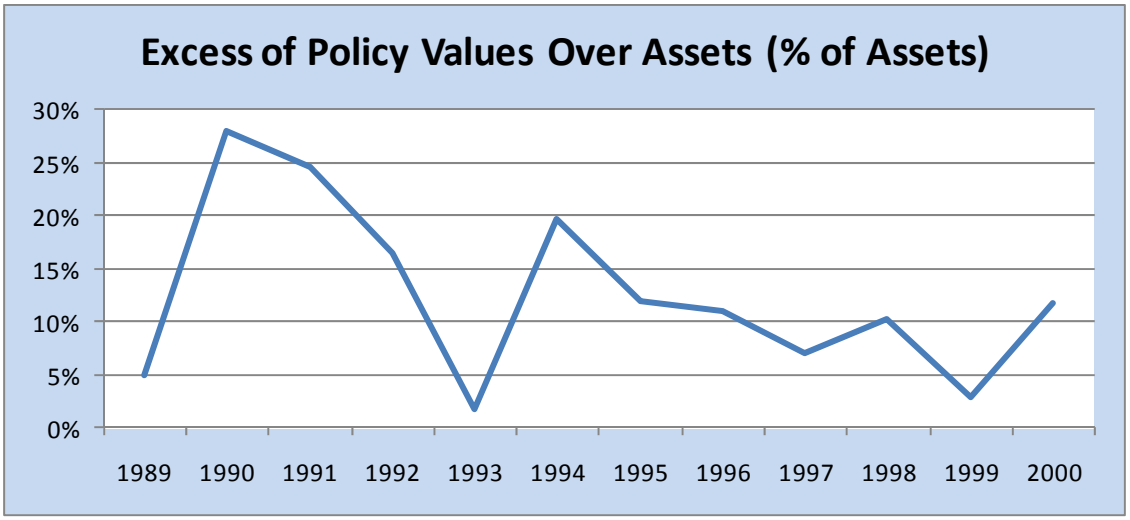

Now one might argue that the Equitable was simply implementing a smoothing policy. But if so, then it was very poorly implemented.

As Mr Clark had explained, an effective smoothing policy would have balance overpayments with underpayments. In some years benefit payments would exceed asset values and in other years the benefit payments would be less than the asset values. But the Equitable always overpaid.

Each year the policyholders received statements showing their Policy Values. The Policy Value represented the amount payable to any maturing policy. The following graph compares the total with-profit policy values to the total assets available to pay these benefits, during the period from 1989 to 2000[21]. The ratio exceeds 100% in every year, and averages 113% over this period.[22] In 1990 (which was just after a market crash) the ratio was 126%. The actuarial Investigating Committee later commented that it was "*wildly and unreasonably optimistic*" to allow the ratio to rise to this level. Over-payments continued even after the Equitable was closed to new business – Policy Values were 119% of the available assets by July 2001.

[21] These figures come from Penrose Table 6.3, and are based on internal valuations conducted by the Equitable's actuaries. The numerator represents policy values for with profit policyholders and includes terminal bonuses. The denominator is calculated as total assets at market value, less assets set aside to meet the liabilities for non-profit and unit-linked policies. It should be noted that the FSA claimed that these figures were unduly pessimistic, since the valuation of assets and liabilities contained some margins. Lord Penrose was not persuaded by these arguments.

[22] According to the Disciplinary Committee report, page 47, the Penrose data for 1998 was incorrect.




Whenever a policy terminated, the policyholder would receive a benefit exceeding his/her asset share[23]. The estimated total amount of overpayments between 1989 and 2000 was about £900 million.[24]

Why did the Equitable follow this policy? Lord Penrose analysed all of the Board papers and actuarial reports relating to bonus decisions during this era. He concluded that the bonus decisions were strongly influence by marketing considerations. The financial press regularly published comparisons of the bonus rates and/or maturity values offered by all the major life insurers, and these comparisons influenced sales. The Equitable's marketing strategy relied on staying at or near the top of the table. Any reduction in bonus rates would have a disastrous impact on sales.

The Equitable was certainly not the only office which was over-crediting at the time. Other insurers were doing exactly the same thing as the Equitable, for exactly the same reasons. This is evident from various comments made in actuarial journals: for example in 1991 the President of the Institute made a presentation to Appointed Actuaries:

> *"He expressed concern at the illogicality of some of the bonus decisions made by Appointed Actuaries. In particular in the last two years 3 offices have made significant leaps in the payout league table. He wondered if this was intellectually credible given the uncertain economic environment in which the decisions were made, particularly at the year end 1990…He warned Appointed Actuaries against being seduced by the low cost (relative to say a promotion or advertising budget) of increasing the payouts over the correct level in order to obtain more new business."*[25]

The life insurance regulators knew that the Equitable was over-distributing – their files show that they were quite concerned about this. But they did not think that it was appropriate to intervene. Bonus rates were a commercial decision which should rightly be determined by the Society's directors.

[23] The Equitable did not have to pay terminal bonuses on surrender values but in practice they did (until the solvency of the company was in danger, when they applied market value reductions
[24] Chapter 6 of the Penrose report has a more detailed analysis of overpayments.
[25] Current Issues in Life Insurance, 6 June 1991, JIA 118, Part III, p 517

## *3.2 Bonuses and Intergenerational Equity*

If an insurer continues to pay benefits which exceed asset shares, then the money must come from somewhere. The Equitable was a mutual with no estate, so options were limited. In the short term, the money depleted the already-low free reserves, endangering the insurer's solvency. Over the longer term, the deficiency had to be recouped from the other policyholders, who would receive less than their asset share. In 1997, the Equitable's Appointed Actuary wrote an internal report which said that it would be necessary to reduce future benefits in order to offset the past overpayments.

> *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.*[26]

The Equitable had firmly stated its principles: it was opposed to inter-generational transfers. It would not reduce current bonuses in order to subsidise future generations. However, in practice, the Equitable did create intergenerational transfers – in reverse. It was boosting bonuses for the current generation, at the expense of future generations.

Later, the Institute of Actuaries set up a Investigating Committee to review the professional conduct of the Equitable's actuaries. This Committee was quite critical of the Equitable's bonus policy. The Board of Directors was responsible for the bonus decisions, but they relied heavily on the advice provided by the Appointed Actuary. Mr Ranson, who was the Equitable's Appointed Actuary from 1982 to 1997, was charged with professional misconduct. In particular:

> *"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."*[27]

The Equitable's actuaries attempted to justify their conduct: they said that they had to take account of commercial realities when making decisions; other offices were over-crediting and they felt compelled to follow suit. The Disciplinary Committee did not accept these arguments as sufficient justification. There was indeed considerable evidence to suggest that other life offices were also over-crediting. But the Equitable was in a weaker position and could not afford to do so without endangering solvency.

[26] This is taken from an internal memorandum written by Mr Headdon in August 1997. It is reproduced in the Penrose report.
[27] Disciplinary Report page 59

## *Terminal Bonuses and Discretionary Benefits*

In *WPWM*, the Equitable's actuaries had advocated another significant change in bonus policy: they recommended that a higher proportion of profits should be distributed by way of terminal bonuses.

Traditionally, prior to the 1960s, most UK life offices distributed surplus by way of reversionary bonuses. Once reversionary bonuses were declared, they became a legal liability of the life office and could not be reduced. The declared bonuses were guaranteed. When regulatory solvency requirements were introduced, life offices were required to hold assets to back these liabilities – including a solvency margin which was designed to ensure a high probability that the guaranteed benefits would be covered. The net premium valuation method controlled the release of surplus over time.

But the Equitable's managed fund approach would only be workable if benefit payments could fluctuate up and down, so the reversionary bonus method was unsuitable.

Fortunately, the life offices had already developed a new method for distributing bonuses, i.e. the terminal bonus. During the 1960s, many life offices decided to invest in more volatile asset classes, such as equities. Since the share market is more likely to fluctuate up and down over time, the life offices decided to offer a new type of bonus, called a terminal bonus, which could also fluctuate up and down over time. When the share market was doing well, a terminal bonus rate would be declared (on top of the usual reversionary bonuses). This would boost the bonuses for any claims made during a specified period (say a year). If the value of the funds' assets fell (e.g. due to a share market crash), then the terminal bonus rate could be reduced or even eliminated altogether. The terminal bonuses were not guaranteed. Hence, there was no legal requirement to set aside any assets to cover the terminal bonus payments.

Initially, in the 1960s, the level of terminal bonus was quite low. Life offices distributed most of their surplus by way of reversionary bonuses, and a relatively small amount was distributed by way of terminal bonus. However over time, many life offices had substantially increased the level of terminal bonuses. At the time WPWM was written, the actuarial profession was trying to develop a more systematic and mathematically sound approach to the distribution of surplus, allowing for a mix of reversionary and terminal bonuses.

In WPWM, the Equitable's actuaries weighed up the relative merits of reversionary bonuses versus terminal bonuses. They started by saying:

> *"If one accepts that the policyholder's key concern is the total proceeds achieved, then the matter of how proceeds are made up between declared and final bonus elements should be of secondary importance."*[28]

They acknowledged that policyholders usually prefer a high level of guarantees:

> *"In practice, policyholders tend to want reversionary bonuses to be as high as possible to avoid the potential volatility of too great a concentration on final bonuses."*[29]

[28] With Profit Without Mystery, Random and Headdon, 1989, para 3.2.6

However, they suggested that there were also good arguments in favour of minimising the declared bonuses, and distributing a greater proportion of surplus by way of terminal bonus.

Ranson and Headdon pointed out that bonus policy would affect investment flexibility. Guaranteed benefits were usually matched by low-risk, low-return fixed income assets. If guaranteed benefits were minimised, this would allow the Society to pursue a more aggressive investment strategy, and this was expected to lead to higher long term average returns. During the 1980s, the Equitable had already adopted this approach, as set out in the 1984 report to policyholders:

> *"In considering the form of the increase, the investment implications of alternatives are important. Since reversionary bonuses, once declared, are fully guaranteed, they need to be backed by fixed interest investments, such as gilts; but we believe that it is in the best interests of members that we should be able to invest extensively in equities and property.*

The Equitable's actuaries also pointed out that a reduction in declared bonuses would make it easier to comply with regulatory solvency standards.

> *"A balance has to be kept between the return which can be consolidated in the form of declared bonuses and that left unconsolidated. Unless that process is carefully controlled, the result could be that too great a proportion of the capital appreciation is distributed in guaranteed form and the office, apart from suffering restricted freedom of future investment, becomes unacceptably vulnerable to a fall in asset values which could render it technically insolvent."*

It appears that most UK life offices were already well aware of the advantages of the terminal bonus systems. Initially, in the 1960s, terminal bonuses had been quite small. But by 1987, terminal bonuses were a very significant proportion of total benefit payments. In a paper presented to the Faculty of Actuaries in 1987, C.S.S Lyon summarised from data from 57 life offices. This table shows the percentage of the maturity benefit arising from the terminal bonus, for a 25 endowment assurance maturing in August 1987, for a male aged 29 years 11 months at commencement.[30]

| Terminal Bonus as a Percentage of Total Benefit | 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 |

[29] With Profit Without Mystery, Random and Headdon, 1989, para 3.2.6

[30] *The Financial Management of a with Profit Long Term Fund – Some Questions of Disclosure* by CSS Lyon, and the subsequent discussion, in Transactions of the Faculty of Actuaries (1987-1989) pages 14 to 63

However, within the actuarial profession, there was already some disquiet about the increasing use of terminal bonuses.

Firstly, the terminal bonus system increased the risk of over-crediting. There was really nothing to prevent life offices from offering unsustainably high terminal bonuses. This would be advantageous to the life office, since the high rates would attract new business. In the short term, there would be some additional cost: the life office would have to pay high benefits to any policies which made claims in the immediate future. But there was no requirement to maintain these bonus rates over the long term, and no need to set aside any reserves, so this strategy was quite affordable in the short term. There was a risk that life offices would use terminal bonus rates to conduct a bonus war.

Indeed, it appears that some life offices were already mis-using terminal bonuses. 1986, the President of the Institute of Actuaries, MH Field, suggested that some recent bonus declarations had been lacking in credibility; that it would be desirable to impose greater controls over the distribution of terminal bonuses; and that it would be desirable to have better disclosure of the method for determining such bonus rates.[31]

There were also concerns about the integrity of the terminal bonus system. Terminal bonuses were forming an increasingly large component of the final benefit payments at maturity. The directors had a great deal of discretion over these terminal bonuses. The directors would inevitably face pressure from the marketing departments: the marketing departments would be interested in maximising sales, not in maximising equity. In 1987, CSS Lyon argued that equity should be the keystone of any bonus policy; and he encouraged the actuarial profession to develop professional standards which reflected this goal.

In fact, by this stage, the Equitable had already demonstrated a willingness to abandon equitable principles in order to improve sales. During the 1980s, certain Equitable policies received "special treatment" in order to meet marketing objectives. The financial press regularly published tables showing the benefits paid on maturing endowment assurance policies from all the life offices, and these had a big influence on sales. In the past, the Equitable was usually at the top of the table. But in the mid 1980s, it was slipping behind its competitors. So the Appointed Actuary suggested that the bonus rates should be increased – but only for those policies which were included in the published table, i.e. maturing policies.[32] Ranson said:

> *"Indeed the existing final bonus rates incorporate a modest measure of bias above their natural level at certain durations where it was felt important from the point of view of published surveys to support the natural figures."*[33]

It does not seem very equitable to boost bonuses on a small group of policies, simply for marketing purposes. But Ranson argued that this was in the best interests of members as a whole, who would

[31] Presidential Address, by Marshall Hayward Fiedl, October 1986, published in Journal of the Institute of Actuaries, Volume 114 (1987). See also *The Financial Management of a with Profit Long Term Fund – Some Questions of Disclosure* by CSS Lyon, and the subsequent discussion, In Transactions of the Faculty of Actuaries (1987-1989) pages 14 to 63

[32] Penrose 3.110; This practice continued for years, see Penrose 4.16.

[33] Penrose chapter 4 para 16

benefit from the increase in premium income (presumably by allowing fixed expenses to be spread across a wider group).[34]

The board agreed that a "marketing adjustment" should be considered by management, as long as it did not cost more than £2 million.[35] These marketing adjustments continued for years.

It appears that other life offices were making the same sort of "adjustments". This issue was raised in a paper on bonus methodology which was presented to the Institute of Actuaries by Needleman and Roff in 1995.

> *"Some actuaries question whether it is legitimate to enhance payouts for competitive reasons. If the volume of maturing policies is small, then the cost of doing this can be minimal, but unreasonable expectations may be created in the minds of policyholders which cannot be met when the volume of maturities increases."*[36]

In the discussion of this paper, several actuaries strongly opposed the policy of varying bonus rates to meet marketing objectives. Others thought that it was acceptable.

Both Field and Lyon suggested that the over-crediting problem might be alleviated if life office provided better disclosure of their terminal bonus rates.

The statutory returns (Form 9) showed the guaranteed liabilities and the level of free reserves. But it did not show the total amount of terminal bonuses. This made it difficult for policyholders to assess the strength of the life office, i.e. the insurer's ability to maintain such bonuses in the future. C.S.S. Lyon pointed out that:

> *"Future terminal bonus on existing policies can represent a major moral charge on the excess of assets over published liabilities but the extent of this charge is not quantified in the returns."*
>
> *….*
>
> *"Given that half, or nearly half, of the maturity proceeds represent terminal bonus, is it satisfactory for the published valuation to ignore its accrual – in other words to treat as free estate the asset appreciation which provides cover for terminal bonus? One result of doing so is to produce Form 9 ratios that are at best uninformative and at worst misleading."*[37]

For example, consider a life office which had guaranteed liabilities of $100 million, and a current terminal bonus rate of 10%. The present value of providing terminal benefits at the current rate would be $10 million. If the life office had free reserves of $40 million, the policyholder would understand that the life office was likely to be able to maintain the terminal bonus rate. But if the

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[34] Penrose 3.110

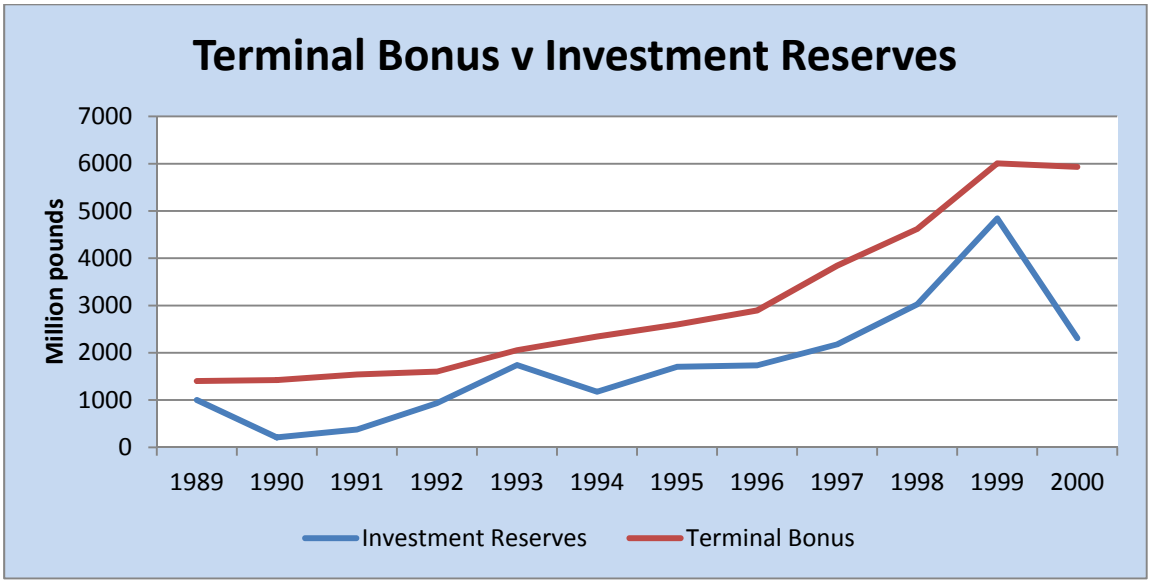
[35] Penrose 3.113

[36] *Asset Shares and their Use in the Financial Management of a With-Profits Fund*, by PD Needleman and TA Roff, British Actuarial Journal, Volume 1 Part 4, 1995

[37] The Financial Management of a with Profit Long Term Fund – Some Questions of Disclosure by CSS Lyon, Transactions of the Faculty of Actuaries (1987-1989) pages 14 to 63

life office only had free reserves of $12 million, then there was obviously a greater risk that the terminal bonuses would be reduced in the future.

Unfortunately, the Equitable was over-crediting: during the 1990s, the free reserves were less than the value of future terminal bonuses. This is shown in the graph below.[38]




If this information had been publicly available, then perhaps the policyholders would have had a better chance of assessing the likelihood of future benefit reductions (or more precisely, financial advisors would have been able to make this assessment and inform their clients). But the policyholders were never given this information. There was no legal requirement to do so. In fact, they were given information which was quite misleading. According to the annual "Dear Policyholder" letters and the With-Profits Guide, the total value of the terminal bonuses at the current rate would, on average, equal the free reserves.

Ranson was later charged with professional misconduct. The charges against him included the following:

> *"You misled policyholders as to the Society's financial position in that the fund values quoted to them were higher than was warranted by the level of the Society's assets"*

The Institute of Actuaries Disciplinary Panel held that these charges were proved.

This problem might have been averted if the actuarial profession had taken action to promote better disclosure of terminal bonus values. The actuarial profession considered whether it would be desirable to do so, but decided against it.

> *"Disclosure and reporting of terminal bonus formed one of the topics discussed by the Valuation Regulations Working Group since 1989. Mr H.W. Froggatt and G.D. Clay introduced this session and suggested that since terminal bonus is such a material part of policyholder payours, disclosure of some information is required. Disclosure may help avoid creating unreasonable policyholder expectations, and provide a basis for comparing the*

[38] This date for this table is taken from the Disciplinary Panel's report page 51

*financial position of offices. It may also help to demonstrate that policyholders are being treated fairly. The working party favoured disclosure of a private nature rather than of a public nature. ..Information such as the aggregate asset shares and the relationship between maturity value and asset shares might be disclosed. The working party did not favour public disclosure through the DTI returns or the with-profits guide."* [39]

The regulatory authorities did collect some information about terminal bonus policy in 1993, when the Government Actuary's Department sent out a survey to all life offices. The Equitable replied to the survey and stated that

*"The smoothing of final or terminal bonuses is determined by the relationship between the accumulation rates determined each year and actual investment earnings. That smoothing is also reflected in the comparison of the aggregate total policy values with actual asset values. In normal circumstances the Directors look to apply a 3 to 5 year averaging cycle but expect to apply that more flexibly in more unusual circumstances."*[40]

It seems that the regulators were satisfied with this rather vague description.

In his investigation of the Equitable, Lord Penrose was rather critical of the poor level of disclosure of terminal bonuses. He commented that

*Had the Society recognised terminal bonuses in its statutory accounts and regulatory returns on any basis consistent with PRE, its financial weakness would have been exposed throughout the 1990s.*[41]

## *3.4 Bonuses and Policyholder Reasonable Expectations*

There were some constraints on the Equitable's bonus distribution policy. The Appointed Actuary was supposed to take account of the Policyholders' Reasonable Expectations before making any recommendations. Actuarial Guidance Note 1 states that

*"It is incumbent upon all Appointed Actuaries to ensure, so far as it is within their authority, that the long term business of the company is operated on sound financial lines and with regard to its policyholders' reasonable expectations."*[42]

The concept of Policyholders Reasonable Expectations had been incorporated into the prudential legislation in 1973. The regulator was given power to intervene

*"when [the regulator] considers the exercise of the power to be desirable for protecting policyholders or potential policyholders of the company against the risk that the company may be unable to meet its liabilities of, in the case of long term business, to fulfil the reasonable expectations of policyholders or potential policyholders."*

[39] Current issues in life insurance, Semianr 22 June 1993, reported in JIA 120, No 3, page 481-482.See also Parliamentary Ombudsman second Report, chapter 6, para 83-84
[40] Quoted in Parliamnetary Ombudsman second report chapter 6, page 114
[41] Penrose 14.186
[42] This is the 1992 version of GN1; the earlier version did not include the PRE requirement.

Apparently, at the time this legislation was introduced, some proprietary life insurance companies had been under-distributing, i.e. withholding profits from policyholders and diverting an unduly high level of profits into the hands of the shareholders. The PRE rules were introduced in order to protect with-profits policyholders from such unfair treatment.

Unfortunately, the legislation did not define PRE; it was an extremely nebulous concept. The actuarial profession did try to address this issue: between 1989 and 1990 a working party tried to develop some principles for assessing PRE. The working party suggested that policyholders would reasonably expect their payouts to reflect their asset share, subject to some degree of smoothing. This fits in the Ranson and Headdon's "managed fund" philosophy, where benefits reflect asset shares.

As we shall see, this was to lead to trouble later. The Equitable's actuaries developed bonus distribution methods based on their own view of PRE – but the courts had a different view.

## *Summary of Section 2*

The Equitable claimed to give "full and fair" distribution of bonuses. In practice, their bonus distributions were overly generous throughout this period. Over-distribution was motivated by commercial considerations, i.e. the need to maintain bonuses at high rates in order to attract new business.

This over-distribution weakened the solvency of the company while creating unrealistic policyholder expectations. It did, however, lead to rapid growth.

The low-estate, high-bonus policy meant that the Equitable was in no condition to deal with unexpected adverse experience.

# SECTION 4: VALUATIONS

## *Freedom with Publicity*

In the UK, the regulation of insurers has always been based on the principles of *"Freedom with Publicity*" . Insurers are required to provide complete and accurate information about their financial strength. This allows prospective policyholders to make informed decisions when choosing an insurer. As a result, there is less need for stringent regulation: so insurers are given more freedom.

The provision of complete and accurate information was essential. Theoretically, this information would be provided by each insurer, in a standardised format, in compliance with statutory reporting requirements. As the Parliamentary Ombudsman noted

> *"…the submission, scrutiny, and publication of the regulatory returns were the prime mechanisms of the prudential regulation of insurance companies (at this time)".*[43]

However, the statutory reporting requirements were sadly deficient. There were a number of loopholes in the rules and the Equitable frequently exploited those loopholes.

As stated above, the Equitable deliberately chose to maintain a low level of reserves. The Equitable's free assets ratio was among the lowest of all the major UK life insurers, throughout the 1990s. However, the situation was even worse than it seemed. During the 1990s, the Equitable's accounts painted an overly-optimistic picture of the insurer's strength.

In this section we describe the methods which were used to boost the reported solvency position – even as the Equitable became weaker and weaker. The regulators, who should have been protecting the policyholders, allowed the Equitable to do so. As a result, the Equitable continued to declare bonuses; and the Equitable's ability to meet policyholders' reasonable expectations was seriously undermined.

**Note on Regulation**

The Department of Trade and Industry (DTI) was responsible for the prudential regulation of the Equitable up to January 4, 1998. On January 5, 1998, Her Majesty's Treasury (HMT) took over the regulatory role. In 1999, the Treasury contracted out this responsibility to the Financial Services Authority (FSA). Despite all these administrative reshuffles, in practice there was some continuity, since the group of people who did the supervisory work were simply transferred from one department to the next. The Government Actuary's Department (GAD) provided advice on actuarial matters throughout this period. [44] For simplicity we will just refer to "the regulators".

## *4.1: Choice of Valuation Assumptions*

[43] PO page 214
[44] Baird Report 2.3

According to traditional actuarial theory, the actuary calculates the value of liabilities and assets, and then calculates the surplus which is available for distribution. However, the Equitable's actuaries reversed this process. In unprofitable years, the Appointed Actuary weakened the valuation basis in order to justify the desired level of bonus.

For example, investment returns were very poor in 1990 (negative 12.2% after deducting management expenses). Nevertheless, policy values increased by 12%. How was this achieved?

The Equitable's Board papers reveal the process.

The Appointed Actuary (Mr Ranson) argued that the Society should set a target bonus rate and then try to achieve it.

> *"In times of depressed markets there are significant constraints on what can be achieved …I think however that our approach should be first of all to identify what we feel to be the 'right' result and then to consider the extent to which that can actually be achieved in practice."*[45]

He pointed out that policyholders would expect to get at least 12%.

> *"The with-profits policyholder has not bought a unit linked policy which directly follows fluctuations in market values, he has been told about the smoothing and averaging approach to with profits business and he will be surprised if his contract does not grow at least in line with something like average deposit rates. I believe that a starting point for the returns to be allotted over the year we might think of something between 12% and 15%."*[46]

The Board papers had "*extensive reference to the adverse marketing implications of cutting or passing bonuses"*.

Ranson pointed out that the Society's financial position would be weakened if they declared reversionary bonuses at the same rate as the previous year. But it could be done. Ranson assured them that

> *"In technical terms, any presentational problems created by declaring a bonus can almost certainly be mitigated by weakening the valuation basis".* [47]

In the end, the valuation interest rate was changed from 8.75% to 10%, which meant that the present value of liabilities decreased by £557 million (relative to a fund value of £5,786 as shown in the accounts at year end).

Lord Penrose noted that without this change in valuation assumptions, the Equitable would have failed to meet the regulatory solvency test in 1990.

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[45] Penrose chapter 4, p129

[46] Penrose chapter 4 para 47

[47] Penrose chapter 4 para 49

Ranson did offer some justification for the change in assumptions. Apparently he believed that market value fluctuations were irrational – the market values did not accurately reflect the intrinsic value of the equities. He expected that dividend income would remain stable, despite the fall in asset values. A fall in market values would simply increase the running yield on the fund. Hence, higher valuation discount rates were justified. (Ranson had previously outlined this theory in WPWM, which was published in 1989).

After analysing the Equitable's annual Board papers during the 1980s and 1990s, Lord Penrose said that:

> *"Maintaining competitive position in terms of bonus record drove distribution policy, and through it, the reserving methods and assumptions adopted. Surplus was a function of bonus policy rather than a value determining the limits of bonus policy."*[48]

## *4.2: Pushing the Regulatory Boundaries 1990-1996*

Mr Ranson did not have unfettered freedom to vary the liability valuation basis. He had to comply with the regulations. Based on the evidence presented to Lord Penrose and the Parliamentary Ombudsman, Mr Ransom pushed the regulatory boundaries to the limits.

Each year, the statutory returns were provided to the Government Actuary's Department (GAD). The GAD would review the valuation; if there were issues, then the GAD would correspond with the Appointed Actuary. The GAD would send a report to the Department of Trade and Industry (DTI). From time to time both GAD and DTI representatives would have meetings with the Appointed Actuary to discuss their concerns.

The GAD's reviews of the Equitable's valuation basis are covered at length in the Penrose report and in the Parliamentary Ombudsman's second report. Year after year, the GAD made critical comments about the choice of assumptions – the margins were very thin, the interest rates looked high, the mortality assumptions looked optimistic, there were no explicit provisions for various special costs such as AIDS mortality, pensions mis-selling costs, future capital gains tax, etc. etc. etc. Occasionally, the regulators expressed concerns about the weaknesses in the valuation basis :

> *"…it may lead to inappropriate conclusions being drawn by policyholders and prospective policyholders as to the financial strength of the Society."*[49]
>
> *"the valuation basis appeared weak and that valuation rates of interest used for certain with-profits business did not appear to make proper provision for policyholder's reasonable expectations."*[50]

[48] Penrose at 3.41
[49] Parliamentary Ombudsman second report chapter 6 para 122
[50] Parliamentary Ombudsman second report chapter 6, para 171

The DTI and GAD held a meeting with Mr Ranson at the end of 1994. At this meeting, Mr Ranson made it clear that it was intending to use the weakest possible valuation basis, in order to show as strong a free asset position as possible. At a subsequent meeting, he claimed that every actuary did so. [51]

The GAD often queried Mr Ranson's assumptions. But it seems that the relationship between Mr Ranson and the regulators was often "prickly". Mr Ranson believed that he had the right to apply his professional judgement to make decisions; he did not appreciate being questioned by the regulators; he did not like it when they asked him to justify his decisions. Mr Ranson was often unco-operative, i.e. he often failed to give regulators the information they requested; he would respond aggressively when regulators challenged his own views.

One of the regulators commented that:

> *"There's not a lot you can do about it if the company chooses to operate its business in that way; we would keep a close eye on it, and we have expressed the view to the company, over at least ten years, that we weren't exactly comfortable with the way that they operated, but the company, I suppose, were arrogant in that respect, and felt that they knew best."*[52]

Appointed Actuaries are normally expected to be prudent and conservative. But Mr Ranson was in a position of conflict of interest. From 1991 to 1997, he was both Chief Executive and Appointed Actuary. As the actuary, he had a responsibility to value liabilities on a prudent basis. As the Managing Director, he was keen to present the Equitable's position in the most positive light, in order to attract new business. The regulators were aware of this conflict and they were not happy about it. However Mr Ranson over-rode their objections and insisted on holding both roles. This is discussed in more detail in Section 7 below.

After their investigations, Lord Penrose and the Parliamentary Ombudsman both criticised the regulators for lax supervision. The regulators defended themselves, claiming that they repeatedly challenged Mr Ranson. But Lord Penrose found that:

> *"There was challenge, but it was ineffective. Unsatisfactory answers were accepted without follow-up. Lines of inquiry were abandoned or postponed in the face of resistance."*[53]

## *4.3. Quasi Zillmerisation*

Sometime in the early 1990s, the Equitable's actuaries decided to use "quasi Zillmerisation" to reduce the company's reported liabilities and hence improve the reported surplus.

However, this was contrary to the valuation regulations.

[51] Penrose 16.203
[52] Baird Report chapter 3 para 3.11.5
[53] Penrose 19.228

The regulations do allow Zillmerisation for annual premium policies. This is a method for spreading new business expenses over time. The life office incurs expenses when a policy is sold; these expenses are recouped over the term of the policy, from the premiums which the policyholder pays each year.

However, the Equitable was selling recurrent single premium policies. Policyholders were not required to make premium payments every year. Many of them did make additional premium payments, but these were purely voluntary. There was no guarantee that such income would be received – and indeed, if the insurer was facing financial difficulties at any time, this source of income was likely to disappear abruptly. So the regulations did not allow any Zillmerisation of new business expenses for single premium policies.

Nevertheless, despite the regulations, Mr Ranson decided to apply a quasi-Zillmer adjustment. This strategy had been mooted in the 1989 paper *With Profits Without Mystery*, and it appears that Ranson incorporated the adjustment into the Society's valuation basis soon afterwards. Later, Mr Headdon explained that the regulations were not well suited to single premium policies, and

> *"Over the years a certain amount of interpretation has been needed to determine minimum reserving requirements…".*

The regulators were apparently unaware of this adjustment. There are some oblique references to this quasi-Zillmerisation in some of the regulatory records, but it was not at all clear. The GAD's actuary later said that

> *"With hindsight you might see Roy Ranson's presentation of the returns as devious and hiding what he was really doing".*

Lord Penrose reviewed the Equitable's returns; he found that there was some mention of the quasi-Zillmerisation, but it was cryptic and it confusing; the GAD's confusion was understandable.

This adjustment to the valuation basis was not discovered until 2000, when the Equitable was up for sale. Ernst and Young were called in to provide a valuation report for the bidders, and they discovered the anomaly.

According to Ernst and Young, the quasi-Zillmer adjustment reduced the reported liabilities by about £950 million in 2000[54]. Correcting this flaw would push the Society to the verge of insolvency.

This was a nasty surprise for the regulators and for potential buyers. In the end the bidders withdrew – one of the bidders explained that

> *"They had reached the view that the Equitable's financial position was considerably worse that they had first thought. The hole was significantly larger than they had expected."*

What was the impact on policyholders? The Appointed Actuary admitted that

[54] Penrose 18.103

> *"Clearly if a substantial proportion of policyholders surrendered, a failure to reflect unrecouped expenses in the basis used could have a material detrimental effect on the remaining policyholders."* [55]

Of course, after the Equitable closed to new business in 2000, thousands of policyholders surrendered their policies.

## *4.4 Future Profits Implicit Item*

In 1990, the Equitable applied for permission to count future profits as an implicit asset for solvency purposes. [56]

At that time, the regulations did allow life offices to take credit for future profits. The Baird report explains the rationale for this:

> "*The economic rationale is that in calculating the liabilities, the valuation regulations specify that the Appointed Actuary must make a prudent and conservative assumption about future investment rates of investment return, and it is then recognised that there is a degree of conservatism or prudence that is built into the system, and it is then permissible that companies may take some of this into account as an item that is available to cover the solvency margin."*[57]

Life offices had to apply to the regulator for permission to use an implicit profit item of a specified amount (i.e. apply for a "section 68" order). The application would be accompanied by a certificate from the Appointed Actuary. This certificate would verify that the expected future profits arising from in-force business would be sufficient to cover the implicit profit item.

Theoretically, the Appointed Actuary would not provide such a certificate unless he had made a thorough assessment of the expected future profits. Normally these calculations would be documented. However, when Lord Penrose examined the Equitable's records, he could not find any records of any such calculations.

The implicit profits item was supposed to represent the release of conservative margins in the valuation basis As noted previously, the Equitable's valuations normally used the most optimistic assumptions permissible under the legislation. This suggests that the Equitable's implicit profit item would be significantly lower than other companies which used more conservative assumptions.

The regulators did not conduct their own assessment of the expected future profits, nor did they ask to see the Appointed Actuary's calculations. As long as the Appointed Actuary provided the certificate, the regulator would provide his approval for the implicit profit item. This was a matter of routine – at the time many life offices used implicit profits items.

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[55] Penrose 18.101
[56] Penrose 7.4 to 7.17
[57] Baird 3.19.3

By the end of the year 2000, the Equitable was closed to new business. The Society was in dire straits. Nevertheless, the regulator allowed the Equitable to include an implicit profits item of £1 billion in the end-of-year solvency calculation.

As Lord Penrose pointed out, this system has "an air of unreality".

- The regulations set out strict rules for the conservative valuation of liabilities, including prudent margins
- These valuations are carefully checked to ensure that the Appointed Actuary has complied with the regulations
- But then the system is undermined by the use of implicit profit items which release these prudential margins
- Furthermore there is no approved method for calculating the expected future profits, and no system for checking whether the Appointed Actuary has correctly calculated the expected future profits
- At the time when the implicit profits item was approved, there were serious doubts about the Societies solvency, so any estimate of future profits should have been carefully scrutinised.

Lord Penrose noted that over time, the Equitable became more and more dependent on the implicit profits item to meet regulatory solvency requirements. The implicit profits item rose from £250 million in 1994 to £1000 million in 2000. Without the implicit profits item, the Equitable would have been "dangerously close to technical insolvency".

In the future, the use of implicit profits items will no longer be allowed. This is the result of a change in EU directives. [58]

## *4.5 Subordinated Debt*

In 1997, the Equitable issued subordinated bonds in order to raise $346 million. [59]

This subordinated debt was designed to improve the Society's regulatory solvency position, by providing greater security for policyholders. If the Society was wound up at any time prior to the maturity date of the bonds, then the $346 million would be available to pay the policyholders. The bondholders would only receive a payment if there was some money left over after all policyholders benefits were paid.

The subordinated debt arrangement would also improve the published level of free assets. The money received from issuing the securities would be included as an asset in the valuation; but the liability to repay the loan would not be included as a liability in valuation. Hence the reported level of free assets would increase.

The existence of this loan allowed the Equitable to increase its distributable surplus and hence pay higher bonuses.[60]

[58] Penrose 20.33
[59] For legal reasons, this was done via a subsidiary, but the repayments were guaranteed by the Equitable.

On the other hand, the subordinated debt would also weaken the Equitable's ability to meet policyholder reasonable expectations. The Equitable would have to pay interest on the loan – and the interest rate on the loan was high, reflecting the level of risk taken by the bondholders. The payment of interest on this loan would reduce the amount available to pay future bonuses.

The subordinated debt could not be counted towards meeting solvency requirements unless the regulator gave consent (via a "section 68" order).The regulators were ambivalent about this proposal. The Government Actuary's Department asked a number of highly pertinent questions:

> *The GAD said that they were uncomfortable with the idea that the Equitable could market the subordinated loan products, treat the proceeds as free capital, and not hold reserves to cover the repayment liability.*
>
> *GAD questioned in what way it would be possible for the loan to be treated as not being a liability on the long term fund and how Equitable could make interest payments and eventual capital repayments, if they held no assets outside the long term fund.*

However despite these objections the Department of Trade and Industry agreed to issue the Section 68 order.

## *4.6 Reserves for Guarantees*

Under the regulations, the Appointed Actuary was required to take account of the value of options and guarantees when determining the value of liabilities. The Equitable had thousands and thousands of policies with Guaranteed Annuity Rates, so the actuary had to determine the appropriate value of these GARs every year.

Arguably, it would have been theoretically correct to set aside reserves for these guarantees every year. Even out-of-the-money options have a value. But many life offices did not set up any reserves until the guarantees moved into the money in the early 1990s.[61]

The Equitable did not set up any reserves. In the regulatory returns for 1993, 1994, 1995, 1996 and 1997, Equitable Life stated:

> *"It was considered unnecessary in current conditions to make explicit provision for the other guarantees and options described [above]."*

Initially, it seems that the regulator had no reason to query this. The statutory returns were very brief and the Equitable did not provide much information about the extent of their guarantees.[62] The GAD later commented that:

> *"…… the presentation of their valuation methodology in their returns was somewhat obscure, and required the reader to pick up comments in three quite separate parts of the*

[60] Penrose 7.35 to 7.64
[61] Professor David Wilkie was critical of unsound reserving methods which were used by some life offices during this era, see Baird 3.28.3.
[62] PO 7.56-57

*return and draw certain inferences from them. There was nothing said to indicate that the level or extent of these guaranteed annuities were regarded as significant"*[63]

But by 1997, the problem of GARs was well known. The actuarial profession was expressing concern about reserving practices. In 1998, the regulator conducted a review of all life offices, checking on their treatment of annuity guarantees. The regulator strongly disagreed with the Equitable's position, and insisted that the Society should set up very large reserves in 1998 (this dispute is described in more detail below, in the section on Guaranteed Annuity Rates).

During this dispute, the Equitable sought legal advice to bolster their own position. Their own legal advisor told them that if they had reserved for the guarantees on the basis specified by the regulator, the Society would have been unable to pay bonuses in previous years.[64] In other words, this under-reserving had caused over-crediting for several years.

In 1997, the Equitable held no reserves for Guaranteed Annuity Options. If they had followed the method of reserving set by the regulators, the amount would have been £675 million. [65] Obviously, the 1997 accounts seriously overstated the Equitable's financial strength.

## *4.7 Financial Reinsurance*

By the end of 1998, the Equitable was in dire straits. The regulator was insisting on full reserving for guaranteed annuity options (GAO risks). If the Equitable set aside the required reserves, it would be just barely meet the minimum solvency standard. The regulators were suggesting that it would be imprudent, under the circumstances, to declare a bonus for 1998.[66] The Equitable argued that it would be "commercial suicide" to skip a bonus.

At this stage, the Equitable came up with a solution. They would buy a reinsurance policy. For a small premium, most of the GAO risk could be transferred to the reinsurer. If the regulator agreed to this arrangement, the Equitable would be able to reduce its GAO reserves by £800 million, and this would significantly improve the regulatory solvency position.

Initially, the regulator was not satisfied by the reinsurance contract. The GAD raised a number of issues about the treaty – including the existence of a cancellation clause.

Eventually, the regulator did agree to this arrangement.

[63] PO 7.58
[64] PO 7.37
[65] Baird 4.15.16
[66] Penrose 17.78, PO 7.79 and 7.80

In fact, the financial reinsurance contract did not transfer much risk to the reinsurer. If the GAO costs exceeded a specified limit, then the reinsurer would pay the claims. But under the terms of the contract, the Equitable would have to repay the reinsurer. One of the senior regulatory officers explained:

> *"The treaty was …a financing operation. This was known and understood at the time by the regulator. In the Society's case the reinsurance treaty was an appropriate way of phasing in the impact of the higher level of reserving that HMT (Her Majesty's Treasury) rightly and firmly insisted on. It was a means of ensuring that the resultant cost, in the form of bonus cuts, was not imposed on a single generation of policyholders whose policies matured that year, but was instead spread over a period of years. It provided that the Society could draw down funds in years when the take-up of GARs exceeded a stated level with repayments made from future emerging margins…."* [67]

As Lord Penrose subsequently explained, the reinsurance treaty supported present regulatory solvency at the expense of future generations of policyholders

The reinsurance contract was rather complex, and in the subsequent investigations there was a great deal of argument about the exact details and the technical compliance with the regulations. But if we take a step back and look at the overall effect of the contract

- The Equitable paid a premium of £150,000
- In return they were allowed to reduce their liabilities by $800,000,000 in 1998

The financial reinsurance was used to reduce liabilities by £1,098,000,000 in 1999, and by £808,000,000 in 2000.

The treaty was renegotiated in 2001. At that time, the one of the regulator's staff members commented that the reinsurance treaty was *'little more than window dressing and the reinsurer has no intention of assuming any serious risk at all'.*[68]

In November 2001, one of the FSA's staff made a note of his discussions with the FSA's legal Counsel. It said

> *Could* [Equitable] *call* [in the Reinsurance Claims Amount] *in cash?*
> [Equitable's solicitors] *said no.*
> [Chief Actuary C] *said makes treaty worthless then.*
> [Counsel] *agreed.*

That same day, the FSA agreed to let the Equitable take credit for a £350 million reduction in liabilities, in respect of the financial reinsurance contract.

The regulators were later severely criticised for allowing the Equitable to take any credit for the financial reinsurance contracts. The Parliamentary Ombudsman found that the FSA was guilty of maladministration because:

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[67] Penrose 7.98
[68] PO page 188

> *the FSA permitted the Society within its returns for 1998, 1999, and 2000 to take credit for the financial reinsurance arrangement that did not reflect the economic substance of that arrangement* [69]

The Government's own review (undertaken by Treasury in response to the Parliamentary Ombudsman's report) concurred with this conclusion.

## *4.8 Overall Impact of Adjustments*

The Equitable adopted a number of strategies in order to improve regulatory solvency. This allowed the Equitable to keep declaring attractive bonuses over a whole decade.

But each of these steps simply "brought forward" future profits.

- A weaker valuation basis meant that a larger share of future investment returns would be needed to pay for current bonuses
- The quasi-Zillmer adjustment meant that a share of future profits would be needed to cover expenses for policies which had already been incurred.
- The implicit profits item meant that future profits were needed to provide an adequate level of security for the bonuses which had already been declared.
- Part of the future investment returns would be needed to pay the interest on the subordinated debt
- If there were any claims under the financial reinsurance policy, the Equitable would have to repay the reinsurer at some future date.

More and more of the future profits had already been spent in advance – leaving less and less available to provide bonuses for future policyholders.

One of Lord Penrose's key findings was:

> *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.* [70]

[69] PO Page 256
[70] Penrose 19.5

## *4.9 Actuarial Professional Conduct - The Side Letter*

Mr Headdon became the Appointed Actuary in July 1997 (replacing Mr Ranson, who retired). The Institute of Actuaries Disciplinary Tribunal later found him guilty of professional misconduct.

His misconduct arose from the financial reinsurance arrangements described above.

The first draft of the reinsurance contract included a cancellation clause. Under certain circumstances, the reinsurer would have the right to cancel the contract. The Financial Service Authority was not satisfied with this arrangement. The Equitable agreed to amend the reinsurance contract; the amendments satisfied the FSA, and this meant that the FSA would approve an £800 million improvement in the Equitable's regulatory solvency position. The revised contract said that:

> *"In the event that the total withheld reinsurance claims balance exceeds £100m at any December 31 negotiations will take place to find a mutually agreeable restructuring of the treaty …..."*

However, Mr Headdon agreed to give the reinsurer a side-letter , which allowed for cancellation. It said :

> *"In the event that the total withheld reinsurance claims balance exceeds £100,000,000 at any December 31 negotiations will take place to find a mutually agreeable restructuring of the treaty. However, should no mutually agreeable solution be found it is the understanding of both parties, which shall have no legal obligation whatsoever, that the treaty will be cancelled by mutual consent as at the above said December 31. In that event, the portfolio at the date of termination will be withdrawn and the Reinsured shall refund to the Reinsurer at the same point in time any Reinsurance Claims balance in full."*[71]

This side letter was not legally binding; but it could still have a material impact on future outcomes. The reinsurance contract had an arbitration clause; if there was any dispute, then the arbitrator might well take account of the side-letter when settling any dispute.

Mr Headdon did not show the side letter to the Financial Services Authority. He later defended this decision, saying that the letter was not legally binding so he did not think that it was necessary for the FSA to know about it.

The FSA discovered the existence of the side letter in 2001. The FSA later claimed that if they had known about the letter, they would not have allowed the Equitable to take so much credit for the financial reinsurance arrangement. After the FSA discovered the side-letter, the regulator banned Mr Headdon from holding any senior managerial position in any insurance company for six years.

The Institute of Actuaries Disciplinary Panel found that:

> *Mr Headdon should have disclosed the Memorandum to the FSA and it was plainly*

[71] Disciplinary Panel para 190-192

*wrong of him not to have done so. It was not for him to have sought to judge its significance or potential significance to the Regulator, that was for the Regulator. 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 Headdon was officially admonished.

# SECTION 5 – Guaranteed Annuity Rates

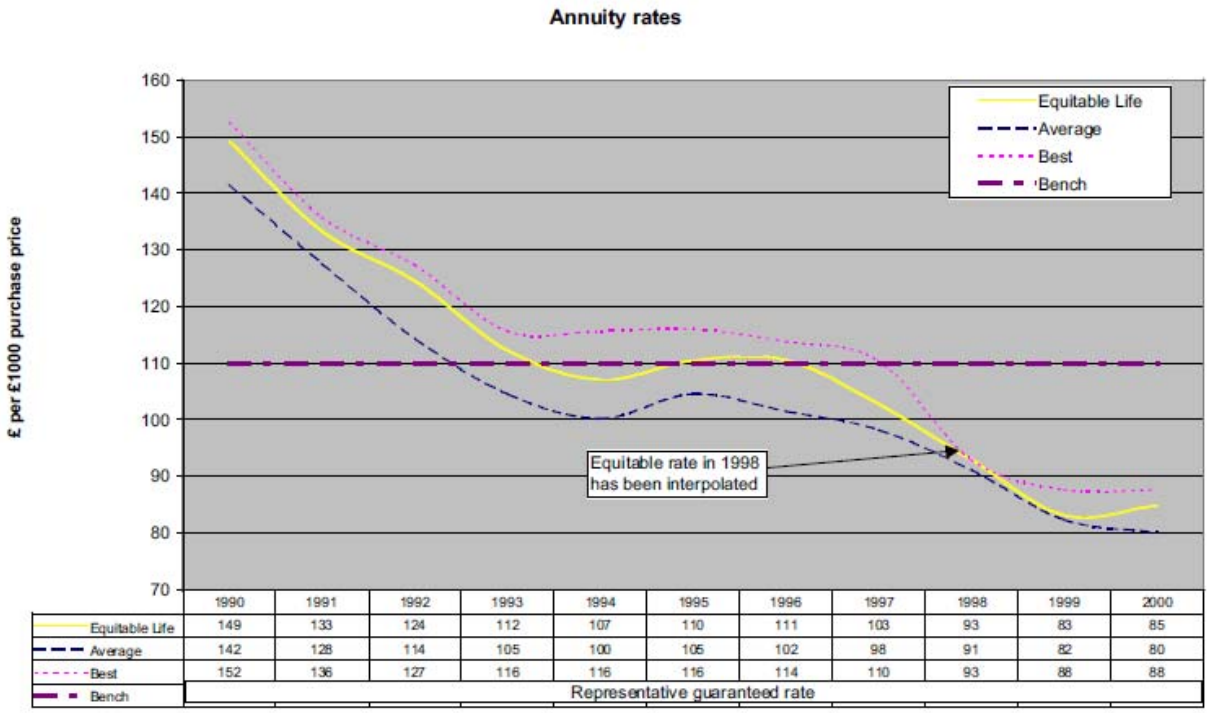
## *5.1 The Differential Terminal Bonus Policy*

The 1990s presented challenges to all life offices which had sold guaranteed annuity rate policies.

The high interest rates of the 1980s had fallen sharply. The following graph is taken from the Appendix to the Baird reort.

Mortality rates improved, too. So the market value of annuities was also falling sharply.

The following graph is taken from the Appendix of the Baird Report. The benchmark lines shows the typical guaranteed rate for a representative Equitable policy.




| | 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 | | | | | | | | | | |

By 1993, the Equitable was in a difficult position. The Guaranteed Annuity Rates were higher than Current Annuity Rates. The guarantees were in-the-money.

Where would the Equitable get the money to provide benefits which exceeded the value of the accumulated lump sum? Some life offices could draw upon their estate to cover the costs, but the Equitable could not afford to do so.

The Equitable could have cut bonus rates on all the with-profit policies. But the actuaries did not believe that this would be an equitable outcome. As stated in *With Profits Without Mystery*, the Equitable's actuaries believed that benefits paid should be roughly in line with asset share. If the Society paid the full guaranteed annuity rates, then some policyholders (the ones with guaranteed annuity rates) would receive more than their fair share, and other (the non GAR policyholders) would receive much less. The non-GAR customers would be subsidising the GAR customers.

In order to avoid this inequity, the Equitable's management decided to introduce a Differential Terminal Bonus Policy (DTBP). A policyholder who took the guaranteed annuity rate would be paid a lower terminal bonus than a policyholder who did not. The reduced terminal bonus would negate the value of the guarantee.

Here is an example of the DTBP for a hypothetical policy. Suppose you have two policyholders who both have an asset share of £100,000. Let's say that both policies have a *cash value* of £80,000, i.e.

this is the lump sum payable at maturity including reversionary bonuses but excluding terminal bonuses. [72]

| | 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 |

Suppose Policyholder A does not have a guaranteed annuity option. The Equitable will pay an additional terminal bonus of £20,000, so that the lump sum is £100,000 (equal to his asset share). This amount can be used to buy an annuity at Current Annuity Rates. If the Current Annuity Rate is 9%, then he will be entitled to an annual pension of £9000 per annum.

Now suppose Policyholder B decides to take up his GAR option, at 10%. In this case, the Equitable will reduce the terminal bonus, in order to eliminate the impact of the guarantee. In this case, if the terminal bonus is reduced to £10,000, then the Guaranteed Annuity will be £9000.

Using this approach, both Policyholders have the same asset share and both receive the same benefit. The annuity guarantee has no effect.

The reduced terminal bonus would be calculated by solving

(Cash Value + Full Terminal Bonus) *Current Annuity Rate

=

(Cash Value + Reduced Terminal Bonus) * Guaranteed Annuity Rate

{see note below}[73]

The Equitable described the DTBP as follows

> *"The approach which the Board has adopted is to seek to ensure through its bonus policy that,* ***so far as is possible, each with-profits policyholder receives benefits whose value represents his appropriate part of the Society's with-profits fund:*** *that is the policyholder's share of the with-profits fund reflecting premiums and other contributions paid by or in respect of him into such fund and the investment returns earned by the Society thereon. Following that approach, the Board calculates final bonuses for those whose policies contain guaranteed annuity rates at different levels depending upon whether the policyholder takes his benefits in "guaranteed annuity form" to which those rate apply or in "fund form" to which they do not. By adopting this approach the*

[72] Penrose 1.15

[73] In some cases, this equation would produce a negative terminal bonus. In this case, if the customer too the guaranteed rate option, the Equitable would provide a pension equal to the cash value multiplied by the guaranteed rate. There were very few policies in this situation in the early years, but this became a more significant problem in later years as the current annuity rates continued to fall.

*Board attempts to provide any given policyholder with benefits at retirement which are, as far as is possible, of the same actuarial value irrespective of the form in which such benefits are taken.*"[74]

The Equitable claimed that they had every right to adopt this policy: the Society's Articles of Association gave the directors a great deal of discretion in the allocation of surplus. Furthermore, the Equitable's actuaries thought that the policyholders did not have a reasonable expectation to receive to any particular amount of terminal bonus. Every year, the policyholders received letters which clearly stated that the current terminal bonus rates were not guaranteed, and could go down.

*The Society believes that the rights conferred on policyholders under such policies do not fetter the* ***absolute discretion*** *over the allotment of bonuses generally conferred on the Board by Article 65 of the Society's Articles of Association, and that so long as this discretion is exercised bona fide and with a proper appreciation of the relevant facts, no policyholder may challenge the exercise of such discretion. The Society considers that, on a proper construction of the policies,* ***no with profits policyholder has a right to require any final bonus to be allotted to him****…and that the level of final bonus (if any) which is made available to any give policyholder is a matter for the Board.*[75]

On the other hand, at least one of the Equitable's actuaries had some serious reservations about the Differential Terminal Bonus Policy. Mr Soundy wrote a memo to Mr Ranson in January 1994.[76]

"*The disadvantages [of the DTBP]*

*The office is not acting with integrity and is effectively reneging on its guarantees.*

*Clients will expect that the full value of the fund will be available at retirement to provide benefits. This is not consistent with having one fund value if GARs are used and another higher value if they are not. While interest rates remain low, therefore, we will receive complaints about this approach. The longer the situation continues the greater the likelihood that complaints become serious. The worse scenario is that we are forced to change our practice and to compensate those who have already taken benefits.*

What would the policyholders think when they realised that their guarantee had been undermined?

Mr Headdon realised that the DTBP might present some "PR problems". In one internal memo dated November 1993, he sets out the dilemma.

*The disadvantage is that presumably we will not be updating any literature in respect of a change to final bonus rates and so clients might feel that we have been a bit underhand in 'sneaking in' this change. Whatever we do, however, there is a fine balance to strike*

[74] Disciplinary Panel citing Originating Summons in the Hyman case
[75] Disciplinary Panel citing Originating Summons in the Hyman case
[76] This memo is reproduced in the Disciplinary Tribunal's report paragraph 81

*between being open and not drawing an excessive degree of attention to the existence of GARs.*

The Board approved the Differential Terminal Bonus Policy in 1993. The Policyholders were not informed in 1993. They were not informed in 1994. They were not informed in 1995. In 1996 and 1997, there was a brief note near the end of the annual bonus notice, but it was rather vague, saying that "*where the policy provides a guarantee of terms on which annuity benefits can be secured, the final bonus then payable will take account of the cost of providing that guarantee.*" This is not a very clear explanation.

Initially, the GARs were only slightly above the market annuity rates, so the discrepancies were small. But over time, the GARs became more and more valuable. Eventually, policyholders began to realise that something was wrong.

In August 1998, some newspapers published articles describing the Equitable's DTBP. These articles were very critical of the Equitable. There were numerous stories about angry and disgruntled customers, who all felt that the Equitable was treating them unfairly and reneging on its promises.

In late 1998, when there was so much adverse publicity, Mr Headdon expressed some regrets about the Equitable's poor disclosure of the DTBP. In an internal memo, he said:

> "*The root cause of this issue is management's failure to make sure that policyholders knew what we were doing and understood why. Without too much exaggeration our approach can be characterised as hoping that annuity rates would never go low enough for the topic to become much of an issue and then putting the minimum on annual statements to cover our backs but without drawing too much attention to it…*
>
> *The lesson to be learnt from this is that it is pointless to think that one will get away with minimal disclosure in the current climate of openness and general suspicion of the actions of insurance companies. When we need to take action which could be unpalatable to some or open to misinterpretation, we need to make it clear what we are doing and to put over the reasons forcibly.*"[77]

By 1998, the regulators were becoming concerned about the DTBP. They were not sure if this bonus policy was meeting the policyholders' reasonable expectations. This was a legal issue, and they were not sure how the courts would interpret PRE. This was a problem for all the life offices which offered guaranteed annuities. In late 1998, the Treasury issued a circular letter to all UK life offices, which said that it might, in some cases, be permissible to reduce terminal bonuses for GAR policyholders – but this would depend on the exact circumstances of each case.[78]

> *… the appropriateness of any adjustments to bonus allocations for participating policyholders would need to be assessed by each office in the context of the reasonable*

[77] This memo is reproduced in the Disciplinary Tribunal para.87
[78] PO page 145; Penrose 17.80-82

*expectations of policyholders. This assessment will be influenced by their policy documents and any representation made through marketing literature, bonus statements or elsewhere".*

In March 1999, the Faculty and Institute of Actuaries issued a position paper on Guaranteed Annuity Rates. It took the same position as the regulators – that is, it might, in some cases, be permissible to reduce the terminal bonuses for GAR policyholders to offset the cost of the guarantee. This was interpreted as support for the Equitable for the Equitable's DTBP.

Eventually, early in 1999, the Equitable decided to settle the matter by running a test case. The courts would have to decide on the legality of the DTBP.

The outcome of the court case is described in section 5.3 below.

It took some time for the test case to be resolved – the final decision was not handed down until mid-2000. In the meantime, the GARs were causing more and more problems for the Equitable : the regulator insisted that the Equitable should set up enormous reserves for the GAR liabilities.

## *5.2 Reserving for GARs*

By the end of 1998, the regulator was insisting that Equitable should set aside reserve to cover the cost of the guarantees. But the Equitable could ill-afford to do so.

The Guaranteed Annuity Rates were in-the-money in 1993, and again in 1995, 1996, and 1997. But the Equitable did not set aside any reserves to cover the additional cost of those guarantees. The Equitable offered some justification for this decision – but it was not at all convincing.

To illustrate the reserving problem, consider the policy described above (reproduced here for convenience). Just before the maturity date, and before the terminal bonus has been declared, t The policy has a cash fund of £80,000 and a guaranteed annuity rate of 10%. What reserve should be held for this policy?

| | No Option | 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 |

- If there was no GAO, then the reserve would just be the cash fund of £80,000. (The terminal bonus is not guaranteed, hence there is no need to hold reserves for this).

- If there is a GAO, then the policyholder has the right to a pension of £8,000 p.a. The value of this pension is considerably higher than 80,000. If we use the Current Annuity Rate of 9% as a rough measure of value, then this pension is worth $88,889 [=8000/0.09].

It would seem sensible to hold reserves sufficient to cover the higher amount, i.e. £88,889. After all, this represents the value of the pension which the policyholder is legally entitled to choose.

However the Equitable rejected this approach. They believed that £80,000 would be an adequate reserve for this policy.

How could they justify this?

This was their reasoning:

- Under the Equitable's DTBP, most people would not bother taking the Guaranteed Annuity Option – after all, it would produce exactly the same benefit, so why bother ?[79] So the percentage taking the GAO was very low.

[79] (In fact they might not even know that the guaranteed rate option existed – apparently the Equitable did not always mention the existence of the option to their policyholders).

- The Equitable's actuaries argued that the level of reserves should reflect the percentage of people taking the option.
- In practice, hardly anyone took up the option, so they argued that it was not necessary to set up reserves to allow for the additional cost of the guarantee.

Of course this argument was fatally flawed.

Equitable's reserving method was based on the assumption that the guaranteed benefits would be covered by the terminal bonus – which were of course not guaranteed and might never be paid. . If the level of terminal bonuses dropped, then of course everyone would take the guaranteed rate option.

As the Government Actuary's Department later observed, the Equitable's reserving method:

> *"… [did] not take account of the key point that the existence of a guaranteed annuity rate increases the level of cash that needs to be paid in substitution for that annuity (as otherwise policyholders would not agree to take the cash sum in place of the guaranteed annuity)"*[80]

In 1997, the Institute of Actuaries set up a Working Party to look at the GAR issue. The Working Party collected information from a number of life offices with GARs, and collected opinions from a number of actuaries. Their report revealed that different life offices were adopting different approaches to reserving for GAR liabilities, but under-reserving was a real problem[81]. The Working Party noted that one approach involved the reduction of terminal bonuses to cover the guarantees (i.e the Equitable's DTB approach). The Working Party considered that this *'could be viewed as unsound because no explicit provision is made for an explicit guarantee'*.[82]

In February 1998, the Government Actuary's Department sent out a survey, asking all life offices to describe their treatment of GARs. The Equitable replied in June 1998, explaining that they had not set aside any reserves for GARs in their 1997 accounts.

The regulators strongly disagreed with the Equitable's approach. The regulators did not require any revision of the 1997 accounts, but they did want to see full reserves, calculated on a proper basis, in the 1998 accounts.[83]

The Equitable was extremely reluctant to agree to this requirement. They estimated that the additional reserves would be between £955 and £1360 million[84]. This would have a devastating impact on the Society. The Equitable told the GAD that there were only five alternatives

1. Refrain from declaring a bonus for 1998
2. Raise capital via more subordinated debt or by financial reinsurance

[80] PO 7.24
[81] PO 7.8 Apparently the report suggested that 75% of life offices were not reserving properly.
[82] PO 7.6
[83] Apparently there was some doubt about whether the regulator could legally require the Equitable to restate its 1997 accounts PO 7.75
[84] The GAD's estimate was considerably higher. PO 7.25

3. Buy derivatives to protect against the GAR risk
4. Change the asset allocation, switching from equities to cash, in order to reduce investment risk (and hence reduce resilience reserves in the liability valuation)
5. Publish accounts showing an extremely weak financial position

In December 1998, the Society's Chief Executive stated that *'the reserving basis required was excessively prudent and bore no resemblance to commercial reality and policyholders would be damaged by this (through a change to a more conservative investment policy, passing bonuses or through there being a run on the office)'*.[85] The Appointed Actuary (Mr Headdon) also complained that the reserving basis was "wildly prudent". The Equitable argued that the FSA's unreasonable insistence of full reserving would be damaging to the Equitable's policyholders.

The Equitable obtained legal advice to support their own views. Their lawyers thought that the FSA approach to reserving was "*inconsistent, prejudicial, wrong in law, invalid, extreme, and amenable to judicial review".* [86]

The FSA also took their own legal advice. The FSA's lawyers thought that full reserving was necessary in order to meet the regulatory requirements. The FSA issued a guidance letter to all Appointed Actuaries, stating that it would be prudent to hold full reserves; but it might be possible to reduce the reserves by "a few percentage points" to allow for the fact that some policyholders might have a good reasons for rejecting the GAO.

The regulators thought that "a few percentage points" meant 5% of 10%. They were surprised when the Equitable's actuaries interpreted this to mean 20% to 35%.

So the Equitable was still under-reserving at the end of 1998. But the regulators decided not to insist on a higher level of reserving. The Equitable was already negotiating the financial reinsurance contract which would justify a lower level of reserves. (This was described in section 4.7 above)

In the meantime, stock markets were still falling; gilt yields were still falling; and the GAOs were becoming more and more valuable.

## *5.3 Equitable Life Assurance Society v Hyman*

Early in 1999, the Equitable decided to run a test case, to verify that the DTBP was legal. They chose one GAR policyholder, Alan Hyman, as the representative of all the GAR policyholders.

The Equitable already had taken legal advice. Their own lawyers thought that the Society had a very strong case, and perhaps this made the Equitable a bit overconfident.

Initially, all went well. The Equitable won the first round of the legal battle. In September 1999, the Vice-Chancellor decided that in favour of the Equitable. More specifically, the judge found that

[85] PO 7.29
[86] Penrose 17.82

- The Articles of Association gave the directors discretion in the determination of bonuses
- This discretion allowed them to set different terminal bonuses for policyholders who took the guaranteed option
- The directors had exercised their discretion rationally and had not neglected any relevant factors in making this decision[87]

However, the case went to the Court of Appeal, and in January 2000 the decision was reversed. Almost immediately, the Equitable decided to appeal to the House of Lords.

In July 2000, the Law Lords ruled unanimously in favour of the GAR policyholders.

Why was the initial decision overturned?

The Law Lords agreed that the Articles of Association gave the directors very considerable discretion: the discretion is "absolute" and "final and conclusive". But they said that even a discretion expressed in these wide terms is not unlimited. The directors must not exercise their powers for a purpose which subverts the basis of the policies sold by the Society, when fairly interpreted.

The QC who acted for the guaranteed-rate policyholders denounced the Equitable's DTBP:

> *"The practice is entirely indefensible. It is contrary to the terms of the policy. The whole purpose of the Guaranteed Annuity Rate is that benefits should be worth more than others in the same circumstances. That is why there are GARS."*

In the final judgement, the Law Lords gave considerable weight to the importance of policyholders reasonable expectations.

> *"The self evident commercial object of the inclusion of the guaranteed rates in the policy is to protect the policyholder against a fall in market annuity rates by ensuring that if the fall occurs he will be better off than he would have been with market rates."*
>
> *"Although discretionary and uncertain, bonuses are a very significant part of the benefits which policyholders would expect. The attractions of a guaranteed annuity rate policy would be much diminished if it were explained that adverse discrimination in bonuses might be involved"*

The policyholders were not informed, when they took out their policies, that differential bonuses would be applied if the guarantee applied. And they were entitled to be given this information, because *"the neutralisation of the benefit of the guaranteed rates was not a course which could reasonably be foreseen".*

[87] Penrose 1.76

As a result of this judgement, the Equitable was in dire straits. They would need at least £1.5 billion in additional capital.

### *5.4 Professional Misconduct: Disclosure Issues*

The test case was initiated in early 1999, and was not finalised until July 2000. In the interim, there was substantial uncertainty about the outcome.

The Court of Appeal announced their decision (against the Equitable) in February 2000. This decision was widely reported in the press. The Equitable's directors decided that it would be a good idea to send a reassuring letter to policyholders.

The Managing Director was Mr Alan Nash, who was also an actuary. He signed the letter to the Policyholders, which included the following statements:

> "*I am now writing to bring you up to date and to reassure you about a number of misleading comments from third parties reported in the press in recent days*"…
>
> …. "*Contrary to many of the reports which have appeared in the press, there would be no significant costs imposed on the Society if the Court of Appeal's decision were upheld in the House of Lords. 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.*'

The Institute of Actuaries Disciplinary Tribunal found that this was misleading. Mr Nash knew that there was a distinct possibility that the House of Lords would extend the Appeal Court decision, imposing even higher costs on the Equitable (and this is indeed what happened). And the Equitable was not particularly financially secure.

Policyholders who relied on this letter when making decisions were understandably angry when the Equitable slashed their bonuses a few months later.

The Disciplinary Tribunal found Mr Nash guilty of professional misconduct, and he was admonished.

## *5.5 Industry Practice on GARs*

The Equitable was not the only insurer facing problems as a result of annuity guarantees.

The Equitable was not the only life office which was under-reserved[88]. The Actuarial Working Party and the GAD survey had both identified that a number of life offices were not holding appropriate reserves for GARs in 1997. In 1999, the FSA wrote a letter to life offices expressing concerns that the regulatory returns of some companies might have presented

[88] PO 7.79 mentions other life offices also under-reserved for GARS in 1997.

*'a materially misleading impression of companies' financial positions as at the end of 1997'.*[89]

The Equitable was not the only life office to consider a differential terminal bonus strategy.

> *GAD also identified Equitable as one of seven offices which had not told policyholders about the existence of a guaranteed annuity option, and one of eight that were considering whether they should reduce the final bonus payment to policyholders with guarantees, to reflect part or all of the cost.* [90]

The Equitable was not the only insurer which was on the verge of insolvency as a result of GAR liabilities.

> *GAD identified Equitable as one of twelve offices with potential solvency margin problems and one of five that could be 'technically insolvent".* [91]

# SECTION 7 AFTERMATH

## *Events Following the House of Lords Ruling in July 2000*

When the House of Lords found against the Equitable, its directors immediately announced that they would be putting it up for sale. In August 2000, they announced that the next annual bonus distribution would be cut by just over half. The amount saved by this bonus cut would be approximately £1.5 billion, i.e. enough to cover the additional liability on GAR policies arising from the House of Lords decision.

Initially, several insurers expressed an interest in buying the Equitable. But by December 2000, all of the prospective buyers for the with-profits fund had pulled out[92]. When conducting due diligence investigations, they had discovered that the Equitable was in a very poor financial condition – much weaker than they had expected, based on the published financial statements.

The Equitable was still facing great uncertainty about the cost of the guaranteed annuity rates. The GAR policyholders would be retiring over the next 15 or 20 years, and the ultimate cost of the guaranteed benefits would depend on interest rate movements and mortality improvements over

[89] PO 7.88
[90] Parliamentary Ombudsman second report, chapter 7, para 68-69
[91] Parliamentary Ombudsman second report, chapter 7, para 68-69

[92] The Society did sell its non-profit fund and unit-linked business, as well as its asset-management, sales force, and customer services division (Ombudsman 2008 at 101.

that period , which were difficult to predict. Furthermore, many of the GAR policyholders had the right to pay in additional premiums at any time, and these additional sums could also be converted to annuities at the guaranteed rates. The size of the liability was theoretically unlimited. As a result, no one wanted to buy the Equitable – it was too risky,

The regulator strongly encouraged the Equitable to close to new business. The directors agreed, and the Equitable closed to new business on December 8 2000.

The Society's financial condition was furthered weakened by falling stock markets in 2000-2001.

Even after the Society was closed, it continued to pay out bonuses at rates which were unsustainable. By June 2001, the Policy Values were 119% of the asset values.

In July 2001 the Equitable cut policy values[93] by 16% for with-profit pension policies, and by 14% for with-profit life assurance policies, and halved the bonus rate for 2001. The management explained that they had no choice. Without the cuts, policy values were much higher than asset shares, so every policyholder who received a benefit was undermining the solvency of the fund. This was unfair to policyholders who remained in the fund.

The policyholders were shocked, dismayed and distraught. There was a public outcry, which led to a Parliamentary enquiry, chaired by Lord Penrose. The FSA also carried out its own internal review , to assess the performance of the Society's regulators (the Baird report). [94]

The Equitable did attempt to sue its auditors (Ernst and Young) and some of the directors. These lawsuits were eventually dropped.

The Society did seek legal advice, to see if the House of Lords decision could be over-turned or bypassed in some way. Their legal advisors (Warren and Lowe) said that there was no realistic possibility of overturning that decision. They did suggest that the non-GAR policyholders might be able to sue for mis-selling.

The non-GAR policyholders – the ones who did not have guaranteed annuity rates – were very unhappy. They complained that the Equitable was guilty of mis-selling. Under the market-conduct regulations, life insurers were supposed to provide their customers with information about risks. The non-GAR policyholders had never been told that their bonuses might be reduced in order to cover the guarantees for the GAR policyholders. The Society and the FSA both hired legal experts to comment on this – they both agreed that these policyholders had quite a good case for compensation. The potential liability was hundreds of millions of pounds.

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[93] The Equitable provided each policyholder with an annual statement of the policy value, including allowance for declared reversionary bonuses and terminal bonuses. Terminal bonuses were not guaranteed. However, the cuts applied to the total policy value. On shorter duration policies, which did not have substantial terminal bonus, this could mean cutting into the guaranteed benefits, ie sum assured plus declared reversionary bonuses. The Equitable stated that despite the cuts, the benefits eventually paid on claims would not be less than the guaranteed amount, but it was not clear how this guarantee would apply.

[94] "Report of the Financial Services Authority on the Review of the Regulation of the Equitable Life Assurance Society from 1 January 1999 to 8 December 2000, which Her Majesty's Government is submitting as evidence to the Enquiry Conducted by Lord Penrose, 16 October 2001.

In September 2001, the Equitable made an offer to the with-profit policyholders in settlement of the GAR and mis-selling claims. The GAR policyholders would receive a 17.5% increase in their benefits, as long as they gave up their rights to guaranteed annuity benefits. The Non-GAR policyholders were offered a 2.5% increase in their benefits, as long as they gave up their right to sue for mis-selling. The proposed Compromise Scheme was accepted by a majority vote.

The Parliamentary Ombudsman also conducted investigations in response to complaints from aggrieved policyholders. The Ombudsman's second report (in 2008) concluded that the regulatory system had failed, and recommended that the government should pay compensation to Equitable policyholders. The government has indeed set up a compensation scheme, although the compensation provided is much more limited that the amounts proposed by the Ombudsman.

Over time, the Equitable's assets have dwindled – assets are now about 15% of the amount held in 2000. Many policyholders lost faith the in Equitable, and they switched out as soon as possible (despite hefty surrender penalties). Over the next few years, the Equitable sold off a lot of its business, bit by bit. At present the Equitable is in run off.

## *Section 7 Corporate Governance and Risk Management*

### *8.1 Dual Roles*

From 1991 to 1997, Mr Ranson was both CEO and Appointed Actuary. The Society's regulators believed that this was undesirable; the Society's Auditors believed that it was undesirable; the Society's President believed that this was undesirable. Nevertheless, this situation was allowed to persist.

The Parliamentary Ombudsman pointed out that the APppinted Actuary had a crucial role in the prudential management of the insurer.

> *Given this regulatory role, which was one cornerstone of the system of prudential regulation in the United Kingdom, an Appointed Actuary needed to ensure that he or she had sufficient independence from the executive management of a life insurance company to enable him or her to undertake effectively the responsibilities (to the company, to its policyholders, and to the prudential regulators and GAD) that were conferred on the Appointed Actuary…. If an Appointed Actuary was unable to secure or retain the necessary degree of operational independence that would raise serious questions about the ability of the Appointed Actuary in those circumstances to perform the regulatory functions conferred on him or her.*[95]

Mr Ranson became the Appointed Actuary in 1982. In 1991, the Equitable informed the regulators that they intended to appoint Mr Ranson to be the CEO. The regulators did not

[95] PO page 228-232

think that this was a good idea, and they communicated this opinion to the Equitable's Secretary. If Mr Ranson was to be CEO, then someone else should be given the role of Appointed Actuary. In response, Mr Ranson explained that the other actuaries who worked for the Society would need more experience before taking on such a responsibility. It would take 12 to 18 months to train up another actuary. Mr Ranson suggested that it would be sensible to allow him to hold both positions in the interim. The regulators agreed (very reluctantly).

Mr Ranson retained the dual role for approximately six years.

Internal correspondence shows that the President of the Equitable was concerned about this situation and thought that these two roles should be separated.

The Equitable's auditors also objected to this situation.

> *"The Society's auditors advised the President that it was essential that the combined role was terminated at the earliest possibly opportunity, as it was 'completely wrong' for any one person to have so much power in his own hands".*[96]

However, in practice, nothing was done.

At the end of his investigation of the Equitable, Lord Penrose made recommendations for regulatory reforms. He recommended a separation of duties: on no account should the Appointed Actuary be the Chief Executive. [97]

## *8.2 External Review of the Actuarial Function*

The UK regulatory system placed a great deal of responsibility on the Appointed Actuary. The Equitable case proved that this system was not working. Lord Penrose pointed out that the system allowed "*an idiosyncratic and autocratic individual, like Roy Ranson, to be charged with running a large with-profits fund without significant control by his colleagues, his board, the auditor or the regulator*."[98]

The Baird report recommended that the work of the Appointed Actuary should be subject to independent external review, conducted to the same standard as an external audit. The Penrose report also suggested that there should be an independent review of the liability valuation, conducted by a qualified actuary; and this actuary should provide an independent report to the policyholders, just as the auditor reports on the value of assets.[99]

[96] PO page 228-232
[97] Penrose 20.58
[98] Penrose 20.57
[99] Penrose 10.45-49; Baird 7.3

## *8.3 Internal Review of the Actuarial Function*

When reading through the story of the Equitable, it is clear that the Appointed Actuaries had a great deal of control. In some cases the Appointed Actuary simply made decisions which were rubber-stamped by the Board (e.g. it appears that the actuaries developed the DTBP themselves, and only informed the Board later). In other cases, the Board made decisions based on the Actuary's recommendations – but they did not have the information or the ability to make an independent assessment of those recommendations. This raises the question of Board membership – should there be stricter "fit and proper person" standards for the directors insurance companies?

The Equitable did have a risk management committee – but it did not review the actuarial department. The risk management committee reviewed IT systems, accounts, fraud controls, and so on. But there was no risk management for product design and development (which was left to the actuary). There was no scrutiny of the Society's liability valuation methodology; there was no assessment of the risks arising from bonus distributions.[100]

## *8.4 Professional Standards and Discipline*

Lord Penrose also noted some weaknesses in professional standards and disciplinary processes.

The profession did not have professional standards for the valuation of guarantees. The profession did not have professional standards to provide guidance in managing Policyholders' Reasonable Expectations. The Appointed Actuary had very wide latitude to exercise his/her professional judgement. This did not produce satisfactory outcomes.

The UK actuarial profession had already taken action to deal with this problem – in the aftermath of the collapse of the Equitable, the Institute's Corley Committee recommended a number of changes to professional standards.

Lord Penrose also suggested that the profession should be more pro-active in disciplining their members. The Institute would respond to complaints from policyholders, but often the policyholders were in no position to assess the professional conduct of an actuary. Lord Penrose suggested that

> *"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."*[101]

[100] Penrose 19.83-100
[101] Penrose 20.60

After receiving the Penrose report, Parliament commissioned a review of the actuarial profession (the Morris Review). The review focused on three broad areas: the regulatory framework for the actuarial profession; the level of choice and competition in the market for actuarial services; and the future role of the Government Actuary and the Government Actuary's Department. It recommended that the regulation of the actuarial profession should be subject to independent oversight by the Financial Reporting Council, and made other specific recommendations. These recommendations have broadly been implemented.