

EQUITABLE LIFE

QUESTIONS and ANSWERS REGARDING THE PRE-1992 WITH-PROFITS ANNUITANTS (WPAs)

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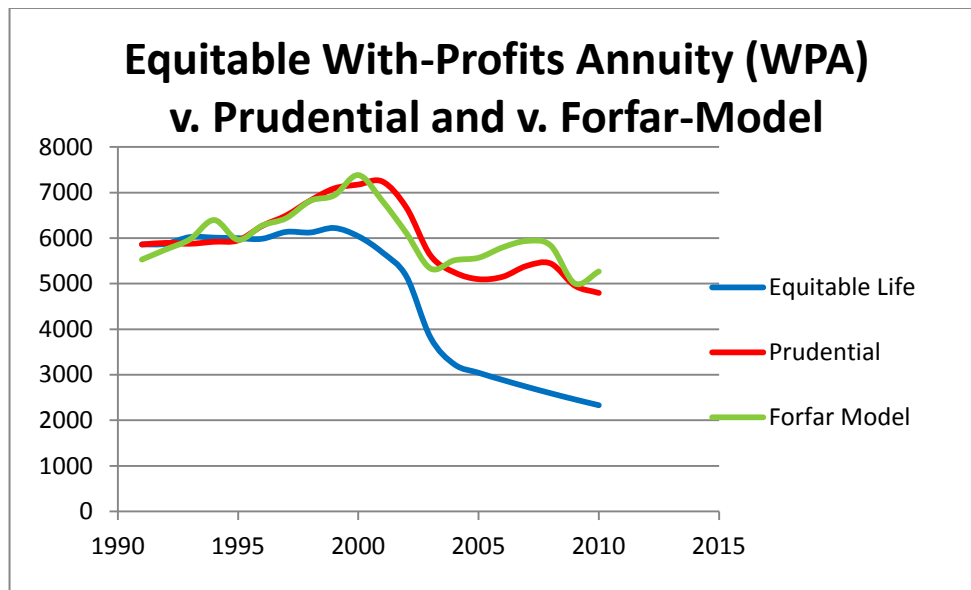
Q1. As the Parliamentary Ombudsman (P.O.) recommended that the aim of the compensation scheme should be "to put those people who suffered 'relative loss' back into the position that they would have been in, had maladministration not occurred", what is the evidence that the pre-1992 with-profits-annuitants (WPAs) of Equitable Life have suffered the P.O.'s 'relative loss' (i.e. a loss relative to a comparable product) and what is the amount of this relative loss?

A. The graph below shows the comparative annuity payments of an average pre-1992 with-profits annuitant (WPA) of Equitable v. Prudential v. Forfar-Model¹ (the latter broadly representing policyholders' reasonable expectations).

The average Equitable Life WPA purchase price was £47,000 and average starting annuity was £5,860 per annum and anticipated-bonus-rate (ABR) 6.5%.

For the above policy, the Equitable's with-profits annuity (WPA) is now providing an annuity income of some £2,300 per annum, whereas the Prudential (and the Forfar-Model) is providing an annuity income of £4,800 per annum i.e. more than twice as much.

The cumulative total loss, up to the year 2010, relative to the equivalent policy² from the Prudential, is £24,755, being more than 10 times the current level of £2,300 of Equitable's annuity (with similar cumulative loss relative to the Forfar-Model).



¹ The Forfar-Model is based on the mortality rates in 1987-1991 and the performance of gilts and equities according to the Barclays Gilt/Equity study with a reasonable allowance for expenses and is available to anyone who asks.

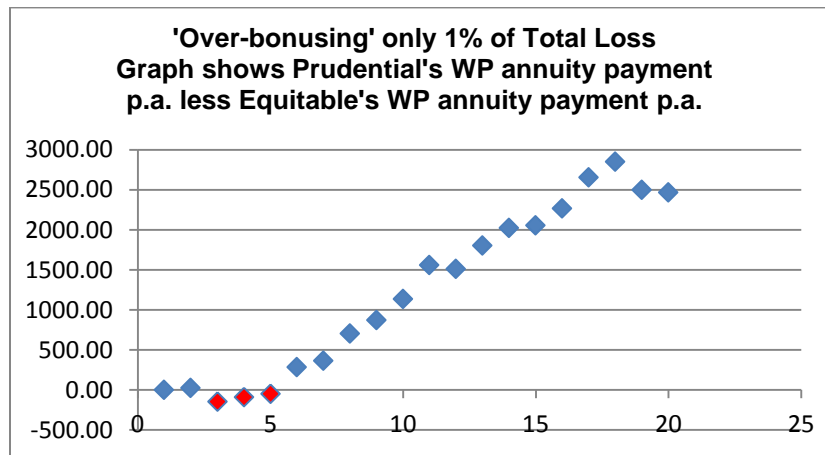
² Single life, same age, same purchase price and same starting annuity at commencement as for Equitable.

Q2. (a) Were the early annuity payments of Equitable’s with-profits annuities (WPAs) artificially high due to the structure of the product and (b) were Equitable ‘over-bonusing’ its with-profits-annuities (WPAs)?

A. No. The evidence shows that it is misconceived to say “...*the early annuity payments of Equitable’s with-profits annuities (WPAs) were artificially high due to the structure of the product*”.

EMAG asked the Prudential for their anticipated-bonus-rates³ (ABR) for several WPA policies with the same purchase prices and the same starting annuity payments as actual Equitable Life with-profits annuities. I have had access to this information. Thus the Prudential’s corresponding with-profits annuity (WPA) product had the flexibility of having both (a) the purchase price and (b) the start annuity level, exactly the same as the Equitable’s-WPA. The Equitable’s monthly annuity payments in the early years are practically the same as Prudential’s annuity payments (and nearly the same as the Forfar-Model) until they fall well below. Thus the evidence does not support (a).

With regard to (b), the answer is that any ‘over-bonusing’ was insignificant. While over-bonusing applied to the Equitable’s pension policies, it did not apply to their with-profits annuities. In fact, the evidence shows (for the example in Q1) that the ‘over-bonusing’ of the with-profits annuities was only £285 in total, being only 1% of the cumulative relative loss of £24,755 (see Q1). Thus the evidence there shows that any ‘over-bonusing’ was insignificant and therefore does not support (b).



Q3. Given the claim (the ‘TW-claim’) that calculations by actuaries Towers Watson show that “..had there been no maladministration, the pre-1992 WPAs would not have performed better than they actually did”, then is the logical conclusion not that the pre-1992 WPAs have suffered ‘no loss’ and should therefore receive ‘no compensation’?

A. I have not seen the calculations by Towers Watson which are referred to, but I find the ‘TW-claim’ very surprising as the evidence (given below) does not support the ‘TW-claim’.

The evidence is that the P.O.'s Report, “*Equitable Life; a decade of regulatory failure*” stated that that maladministration, leading to injustice, arose because GAD/DTI failed to take action to question and resolve issues including:-

³ different from Equitable Life’s ABR, as the calculation of future with-profits annuity payments by the Prudential is done in a different way

- (1) policyholders' reasonable expectations (PRE) not being protected - the protection of policyholders' reasonable expectations being a primary responsibility of regulation⁴,
- (2) guarantees annuity risks not being met,
- (3) annual-regulatory-returns from, and including, the year 1990 bring misleading,
- (4) failure to reserve for guaranteed annuities,
- (5) a reduction in liabilities as a result of reinsurance contract that did not transfer any risk,
- (6) aggregate policy values being in excess of assets,
- (7) bonuses, including terminal bonus, not being 'affordable and sustainable'.

Furthermore, the Proven Findings of the '**Independent Disciplinary Tribunal of the Actuarial Profession**'⁵ found that,

- (8) Equitable Life "...was not operated on a sound financial basis", and "...was not run with regard to policyholders' reasonable expectations (PRE).."(see note 5),

and expelled the CEO/Appointed Actuary from the actuarial profession because, among other things,

- (9) he had not carried out his compulsory duty, as Appointed Actuary, to advise the Board of Equitable Life of his interpretation of policyholders' reasonable expectations (PRE) and,
- (10) he had not advised the Board of Equitable Life that the Equitable's terminal bonus was not covered by assets.

In fact, the '**Independent Disciplinary Tribunal of the Actuarial Profession**' (page 51, para.111 of their Report –see Note 5) found the Equitable's CEO/AA had told Equitable's Board that terminal bonus was, on average, covered by the assets but the **Independent Tribunal** provided the evidence to show that terminal bonus was never covered (from 1989 onwards) by the assets.

Under the Act establishing the office of the P.O.⁶, the P.O. is not required by the relevant law to state what the resolution of the above issues should have been (it is enough for the P.O. to have concluded that GAD/DTI failed to take the action they should have taken). However, there was a professional meeting of actuaries in 1989 at the Institute of Actuaries and in 1990 at the Faculty of Actuaries⁷ where Equitable Life presented its business strategy and at which the some of these issues were discussed. I was present at one of these meetings.

In my view, following the professional actuarial meetings mentioned above, it was reasonable for the following regulatory action to have been taken:-

⁴ P.O. Report in Part/Chapter/Paragraph, 1/6/88 – in July 1993 the D.T.I. stated in writing to all life offices:-"*The Department [the D.T.I.] has .. a particular responsibility to protect policyholders' reasonable expectations [PRE] ...*".

⁵ In the matter of the Equitable Life Assurance Society and the Hearing of the Disciplinary Charges brought by the Investigating Committee, 2007 http://www.actuaries.org.uk/sites/all/files/documents/pdf/tribunal_rep_elas.pdf Under the Insurance Companies Act 1982 11 (2) (ab) "*The Secretary of State may direct that a life office cease to be authorized if the criteria of **sound and prudent management** is not or has not been fulfilled or may not be or may not have been fulfilled...*" and Schedule 2A 5. requires a life office "*...to conduct its business in a **sound and prudent manner***" and Sch. 2A 7. states that "*...the criteria of **sound and prudent management** is not fulfilled if the life office fails to conduct its business with due regard to the interests of policyholders and potential policyholders*".

⁶ Parliamentary Commissioner Act 1967 where § 5(1) says the P.O. "*...may investigate any action taken by ...a government department ...being action taken in the exercise of administrative functions of that department in any case where ... a member of the public ...claims to have sustained injustice in consequence of maladministration...*".

⁷ The Equitable's professional actuarial paper '*With-Profits without Mystery*'. In 1990, Equitable had (i) no *Smoothing-Fund* (ii) no *Estate* (iii) some 50% of the fund contained *annuity-guarantees* (iv) the ratio of aggregate policy-values to assets was nearly 128% (at end-1990) (v) Equitable were expanding at a fast rate (well above investment-return) (vi) actual-results on endowment and pension policies, but not with-profits annuities, were in excess of *asset-shares* - GAD's 'over-bonusing' (P.O. Report 1/10/194) (vii) the bonus notices sent to policyholders each year showed the accrued terminal bonus and (viii) bonuses on the Retirement Annuity Policy was shown as an amount of cash, despite the policy being written as a deferred annuity i.e. in 'annuity' form (on a deferred annuity, bonuses would normally be shown as an amount of annuity not as an amount of cash).

- (1) the bonuses of Equitable Life to have been required to have been reduced,
- (2) Equitable to have been required to build up an Estate in order to meet its un-hedgeable annuity guarantees⁸ - where having an Estate means building up spare money over time to meet un-hedgeable guarantees, without affecting the reasonable expectations (PRE) of other policies without annuity guarantees,
- (3) Equitable's fast new business growth (well above its investment earnings) to have been required to have been curtailed⁹,
- (4) Equitable to have been questioned in regard to its practice of showing terminal bonus each year (on its annual-bonus-notices to policyholders)¹⁰,
- (5) declaring reversionary bonus and terminal bonus on a deferred-annuity (the principal policy benefit) in the form of a cash amount (as opposed to as an additional annuity) to have been questioned as an unusual practice¹¹.

The P.O.'s maladministration dates from the date of GAD's scrutiny of the 1990 Regulatory Returns¹² (in 1991, see Q4). The year 1991 is some nine years before the House of Lords judgment in 2000.

In my view, if the above regulatory action had been taken in 1991, there would not have been a House of Lords case some nine years later, as, inter alia, regulatory action would have ensured that the Board of Equitable Life were properly informed about important financial matters as they affected Equitable Life (in particular about the non-sustainability of terminal bonus, about the inability of Equitable Life to fulfil the regulatory requirement of meeting policyholders' reasonable expectations (PRE), about the need to have some spare money – an Estate - to meet un-hedgeable guarantees if they 'bit', about the need to keep policyholders well informed about PRE matters etc.). As a result, in my experience of attending Board meetings of my former life office as their Appointed Actuary, the Board would have cut unsustainable bonuses and put a stop to showing terminal bonus each year on Equitable's annual-bonus-notices to policyholders (this is the aspect that caused certain policyholders to bring the House of Lords case¹³). That means that, absent maladministration, the regulatory issues would have been addressed and resolved some nine years before, and, if that had been done, there would have been no House of Lords case.

On the basis of the above, in my view, Equitable's ongoing monthly annuity payments to its pre-1992 WP annuitants (as well as post-maladministration WPAs) would have been to-day on a par with the Prudential's annuity payments (shown in the graph in Q1) and at similar level to the Forfar-Model. ***Therefore “..had there been no maladministration, the pre-1992 WPAs would have performed better than they actually did” and on a par with the Prudential's corresponding WPA,***

Q4. The P.O. finds, in respect of the 1990 (not 1991) Annual Regulatory Returns, that (a) GAD/DTI failed to question and resolve the issues arising (b) the Returns were

⁸ irrespective of whether or not a differential terminal bonus policy (DTBP) was within directors discretion, i.e. the question to the House of Lords was whether the directors of Equitable Life had the discretion to use a lower terminal bonus from that which Equitable had shown on its annual-bonus-notices to policyholders – the House of Lords decided that the directors of Equitable Life did not have this discretion.

⁹ as it is well known to actuaries that a rate of expansion above the rate of investment earnings, and actual results above what the life office has earned from its investments, is incompatible with building up an Estate,

¹⁰ in my view Equitable would have been persuaded to cease this unique practice as (a) no other life office operated this practice and (b) it was part of actuarial training, when I was an actuarial student, that you do not show terminal bonus on the annual-bonus-notices sent each year to policyholders - the reason being that terminal bonus can only be determined at the maturity/termination of a policy, because of the volatility of gilts and equities- see note 7(vii) above),

¹¹ and in my view, as a consequence of investigations, this practice would have ceased – see note 7(viii) above.

¹² P.O. Report 1/11/33 where the P.O. states “I have found specifically the GAD failed to question the Society about issues that arose from the 1990 Regulatory Returns..” and also notes 14 and 15 below,

¹³ as Equitable would have been stopped quoting terminal bonus on its annual-bonus-notices to policyholders so the question of policyholders receiving the terminal bonus as shown on their annual-bonus-notices and, in addition, receiving the guaranteed annuity rate as shown in their policies, would not have arisen. Hence, there would have been no House of Lords case.

misleading and (c) these Returns were scrutinised by GAD on 24 and 27 July 1991 with the final scrutiny on 29 November 1991¹⁴. The 1990 Returns were sent to Companies House (i.e. published) on 29 June 1991¹⁵. Therefore, how can it be that we have been told the “....the first returns that the Ombudsman found were affected by maladministration were those of 1991, which would not have influenced policyholders' decisions until September 1992”.

A. The evidence¹⁶ is that the above statement is not true and should be:-

“....the first returns that the Ombudsman found were affected by maladministration were those of 1990 (not 1991), GAD's initial two scrutiny actions were 24 and 29 July 1991 and scrutiny completion was on 20 November 1991. The 1990 Returns were available to the Press and public from July 1991 onwards, so could have influenced all policyholders' decisions from July 1991 onwards.... but the annuitants were 'trapped' and could not transfer elsewhere even if they had wanted to.”

The evidence is that the operative date for the 1990 Returns for (i) submission to Companies House (which covers publication and availability for the financial press or the obtaining of the 1990 Returns from Equitable Life itself) and (ii) submission to the DTI/GAD, is 27 June 1991¹⁷.

GAD's initial scrutiny, was in July 1991 and completion of their detailed scrutiny was 20 November 2011 (see note 14). Also among the complaints¹⁸ by members of the public (considered by the P.O.) was the complaint (complaint I) that the Regulatory Returns were misleading (and issues not resolved) from 1990 onwards (and this clearly included the Regulatory Returns for the year 1990) and this complaint was upheld by the P.O..

Q5. Can the fact that the 'purchase decision' decision, of some, but only some, of the pre-1992 WPAs was made before the maladministration commenced, justify all the pre-1992 WPAs receiving 'no compensation' (the 'purchase decision' argument) when the post-1992 WPAs are receiving full compensation?

A. No, for the undernoted reasons.

As stated above, the P.O.'s 'Ten Findings of Maladministration' do not make any distinction, as far as the affect on monthly annuity payments received after the maladministration are concerned, between:-

- (i) the WPAs who made their purchase decision pre-maladministration (the pre-maladministration-WPAs) or
- (ii) the WPAs who made their purchase decision post-maladministration (the post-maladministration-WPAs).

The P.O. found that the regulatory issues, dating from the 1990 Returns, were not resolved and, as a consequence, the P.O. found there to be injustice¹⁹ to all the WPAs

¹⁴ P.O. Report, Part 3, page 64 and 66 and e.g. P.O. 1/12/8, 1/13/72,88,89 and 98.

¹⁵ P.O. Report Part 3, page 33.

¹⁶ P.O. Report 1/10/7, the P.O. states “my second finding of fact...for the year-ends for 1990 to 1993...GAD failed to satisfy themselves, that the way the Society had determined liabilities and sought to demonstrate that it had sufficient assets,....accorded with the applicable regulations” also 1/10/14,138, 158, 159, 178, 183, 202, 234, 304 and 1/11/11, 40 and 1/12/60 ,100 and 1/12/2 states, in respect of the 1990 Annual Regulatory Returns that “ the failure by GAD ...to question and seek to resolve questions related to.. the valuation rate and the affordability of bonus.. constituted maladministration...”.

¹⁷ P.O. Report Part 3, pages 59.

¹⁸ P.O. Report 1/13/72, 1/13/88, 89 and 98.

¹⁹ P.O. Report 1/13/181, the P.O.'s two criteria for injustice are both satisfied, namely (i) relative loss and (ii) reliance on the regulatory returns as widely drawn by the P.O. - see P.O. Report 1/12/96 and 97

no matter when they had taken their decision to invest (their 'purchase decision') because:-

- a) all WPAs suffered 'relative loss' after the date of maladministration (see evidence under Q1), and
- b) in 1991 and thereafter, there were favourable articles (wrongly, as it turned out) about Equitable Life in the financial section of newspapers and this was enough to meet the P.O.'s criterion of the WPAs having '*relied on the Regulatory Returns*'²⁰.

Sir John Chadwick also found that all the pre-maladministration-WPAs should be compensated for the particularly poor monthly annuity payments which were received after the date the maladministration, even if they had made their original 'purchase decision' prior to the maladministration.

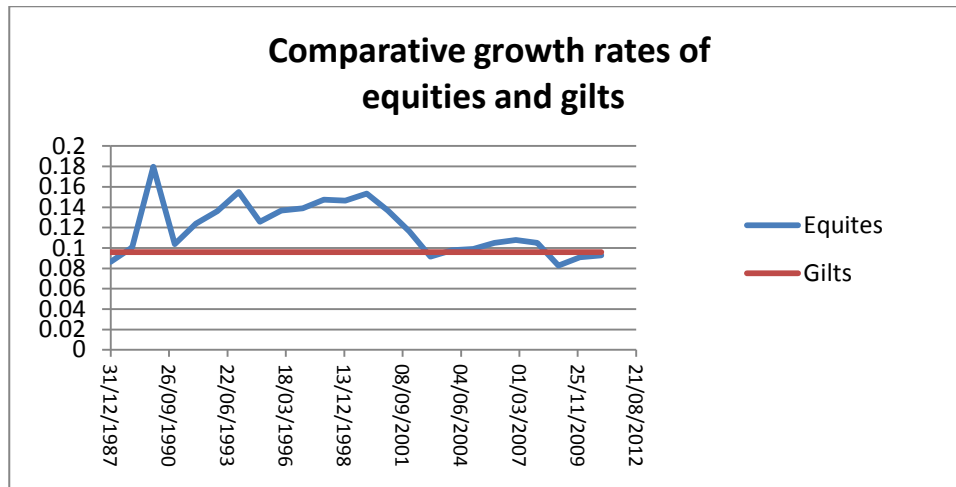
For the above reasons, in the P.O.'s view²¹ and in my actuarial view, if the matters raised in P.O.'s Findings on maladministration leading to injustice had been timeously addressed, Equitable would have been able to meet policyholders' reasonable expectations (PRE).

Thus the 'purchase decision' argument is not supported by the above evidence.

Q6. Was the reduction in the level of with-profits annuity payments due to poor investment market performance?

- A. No. The evidence from the Barclays Gilt/Equity study does not support this.

For example, between the start of 1987 and the end of 1999 the equity market increased at an average yearly growth rate of 15.3% per annum²² and considerably higher than the growth in gilts (British Government Securities) which is the determining factor for non-profit annuities. For comparison, for the year 1987, the average gilt rate was about 9.6%. The comparative growth rates between equities and gilts for 1987 annuitants are shown on the graph below. It will be seen that the growth in equities for the 1987 annuitants is, on average, well above the growth in gilts.



²⁰ P.O. Report 1/12/96 ad 1/12/97

²¹ P.O. Report, Forward/page viii, where the P.O. refers to "...a satisfactory resolution..." if the regulators had "...acted on all the occasions when they should have acted".

²² Barclays Bank Gilt/Equity Study where, with dividends re-invested, the index level went from 16,139 at the end of 1987 to 103,120 at the end of 1999, an increase of over 539% in 13 years, equivalent to an average growth rate of 15% per annum - as $103120/16139$ to the power $1/13=1.15$.

Q7. Is it the case that, once a with-profits annuitant (WPA) had purchased their annuity policy, they did not have the option to transfer it to another life office, even if they had wanted to i.e. were they 'trapped'?

A. Yes. For example, the pre-1992 with-profit annuitants (WPAs) may have wanted to transfer to another life office in late 1991 but were 'trapped' (i.e. by law, annuitants could not transfer).

Q8. What is the source of the evidence on which you have based your figures and calculations?

A. The source of my evidence is:-

- (1) The Report of the Parliamentary Ombudsman (P.O.) "*Equitable Life; a decade of regulatory failure*",
- (2) The 'Independent Disciplinary Tribunal of the Actuarial Profession' regarding the Equitable Life case (see note 5 for the website),
- (3) Equitable Life supplied details to EMAG of their bonuses and with-profits annuity calculation method,
- (4) The Prudential supplied details (for the same ages - single and joint life - purchase price and initial annuity level as several actual Equitable Life cases) to EMAG of their equivalent anticipated-bonus-rate (ABR). They also supplied details of their historic contractual and terminal bonuses on with-profits-annuities since Prudential started issuing with-profits-annuities,
- (5) The 1987-1992 mortality tables came from the Institute and Faculty of Actuaries,
- (6) The investment performance of gilts and equities (with income reinvested) came from the Barclays Gilt/Equity Study,

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