



The Pensions Institute

Out of the GAR Frying Pan into the GIR Fire:

**An Independent Evaluation of the Current State of the With-Profits Fund of the
Equitable Life Assurance Society**

**Professor David Blake PhD,
Director of the Pensions Institute,
Birkbeck College,
University of London,
London W1T 1LL, UK**

**Prepared for the Equitable Members' Action Group
(EMAG)**

10 May 2002
(Revised 18 May 2002)

This report is available at:

http://www.pensions-institute.org/reports/equitablelife_DBreport2.pdf

and

<http://www.emag.org.uk>

Table of Contents

Terms of Reference	3
Conclusions.....	4
1. Introduction.....	6
2. Evaluation of the Current State of the With-Profits Fund of the Equitable Life Assurance Society.....	7
Appendix A: Background	15
Appendix B: Documents used in this Evaluation	24
Appendix C: Contractual Terms used in relation to Benefits and Policy Values of the Equitable Life With-Profits Personal Pension Plan	25
Appendix D: About the Author of this Report.....	26

Terms of Reference

To prepare an independent evaluation for policyholders of the current state of Equitable Life's with-profits fund and prospects in the light of the 15 April 2002 announcements and the 2001 Report and Accounts. Also to revisit the compromise scheme proposal documentation of December 2001 (and the 2001 interim accounts) in the light of this new information.

To be completed by 10 May to aid policyholders' understanding of Equitable Life's situation prior to the AGM on 27 May.

Notes:

1. The Report is an independent report under Part 35 of the Civil Procedure Rules on Experts and Assessors.
2. The Report will be available at http://www.pensions-institute.org/reports/equitabliflife_DBreport2.pdf or <http://www.emag.org.uk> only.
3. The Report is not intended to constitute advice to policyholders and the author will not engage in any correspondence with policyholders in connection with the Report.
4. The Report was written to a very tight deadline, and should be considered preliminary.
5. Equitable Life's statutory returns for 2001 were not available at the time of writing.

Conclusions

1. The *Annual Report and Accounts 2001* is lacking in a number of respects:
 - there is no clear statement of the with-profits fund's available assets or any comparison between the available assets and aggregate policy values, where the latter are differentiated between guaranteed and non-guaranteed elements
 - there is no statement of whether the available assets are within the range of $\pm 5\%$ of aggregate policy values as indicated in the Appointed Actuary's Report of 22 November 2001
 - there is no reporting of the number of members of the with-profits fund at the beginning and end of year.
2. The Equitable Life with-profits fund appears to be close to technical insolvency. The fund for future appropriations is so small that, given the commitment to add guaranteed interest rates (GIRs) of 3.5% a year to guaranteed values, the with-profits fund could not take many more negative investment returns before becoming technically insolvent. Policyholders have had the exit penalty (market value adjustment) raised to 14% and the maturity value of their policies reduced by 4%, the latter being an unprecedented new device for reducing policy values. Furthermore policyholders have not received annual statements to date and are currently subject to a nil interim bonus. All of this indicates just how serious the situation is at Equitable. Under these conditions there is no possibility for the fund to open to new business. Without a radical change in structure, the fund will remain a run-off fund heavily invested in bonds.
3. An obvious radical change in structure would be for the fund to convert itself into a unit-linked fund. This would allow the fund to raise its weighting in equities whenever this was thought appropriate given market conditions. This would clearly be attractive to the non-GIRs who are on average younger than the GIRs and who would have a longer period to benefit from superior long-term equity performance. An alternative would be to establish a unit-linked fund alongside the with-profits fund and allow policyholders to join without facing an exit penalty. In both cases GIRs who participated would have to give up their GIR rights. A less radical change of structure would be to recognise the true current status of the fund and convert it into a closed non-profit fund.
4. Rather than consider any of these changes in structure, the Board's strategy is to use retentions to build up a smoothing fund in the belief that the fund can continue as a with-

profits fund. However, it is now clear that the ELAS fund has no future at all as a with-profits fund. In fact it is no exaggeration to say that the non-GIR policyholders are no longer members of a with-profits fund: rather they are members of a potential with-losses fund. While the fund remains solvent, the entire investment risk falls on the non-GIR policyholders (who account for just 25% of the fund by value), yet the investment benefits (above the GIR of 3.5% p.a.) are shared amongst all policyholders. With-profits policies with their lack of transparency are now widely discredited, not least because of what happened at Equitable, and accordingly should be abandoned as a product sold to retail customers in the UK.

5. The compromise scheme proposal documentation of December 2001 (and the 2001 interim accounts) indicated to policyholders that the with-profits fund would face an uncertain future only if policyholders failed to vote for the compromise scheme proposal that removed the problem with guaranteed annuities (GARs). These documents gave no indication that, even if the CSP was approved, the with-profits fund would be close to technical insolvency. They also gave no indication that a GIR problem was facing policyholders immediately over the horizon.
6. Once again the ELAS actuaries have been exposed for their poor understanding of financial market risk and the consequences of offering guarantees without investing in appropriate matching assets. Just as they failed to understand the risks underlying guaranteed annuity rate options, so they have failed to understand the risks underlying guaranteed minimum annual returns or GIRs. The non-GIRs would appear to have a strong case for misselling.
7. Finally as a public policy recommendation, I reiterate what I said in my first Report: in future, investors should only be permitted to participate in the same pooled investment fund if they all get the same expected (or *ex ante*) return. There will be circumstances where investors will get different realised (or *ex post*) returns on their investments in the same pooled fund. For example, annuitants within the same mortality pool will get different realised returns, since some will die earlier than others, but they still have the same expected returns at the time that the annuity is purchased. In the case of the ELAS with-profits fund, the non-GIRs will only be allocated the same bonus as the GIRs if the fund for future appropriations is sufficiently large. Since the GIR is guaranteed whereas the non-GIR bonus is not, the accrued non-GIR bonuses can be progressively withdrawn if this is necessary to ensure that future GIRs are made. Such a situation should not in future be permitted in collective investment schemes.

1. Introduction

1.1 In December 2001, I was asked by EMAG to assess the adequacy and objectivity of the information provided by the Board of the Equitable Life Assurance Society (ELAS) in connection with the Compromise Scheme Proposal (CSP). My Report was published on 19 December 2001.

1.2 I concluded that the information provided by the Board was inadequate in the following respects:

- Most of the information concerning the status of the fund was out of date
- There was virtually no information on what was going to happen to the fund after the vote
- What both GAR and non-GAR policyholders were foregoing by voting for the CSP was not clearly spelled out
- Alternatives to the CSP that would be fairer to non-GAR policyholders, such as splitting the fund into GAR and non-GAR funds, were not adequately considered
- A YES vote would not necessarily put an end to further claims against ELAS and an assessment of the likelihood of this happening was not provided.

1.3 Despite the inadequacies of the information made available to policyholders, the CSP was approved by both policyholders (in January 2002) and the High Court (in February 2002). Over the course of one year around a million policyholders had the value of their policies cut by an average of 25%. But according to Vanni Treves, ELAS chairman, the future would be much brighter once the compromise scheme was approved. He said on Radio 4's *Money Box* on 12 January (the day after votes on the CSP closed): 'We will have a more strong bonus policy. We will have stronger investment flexibility. Crucially, many, many of our policyholders who've been worrying themselves sick, will worry much less'.

1.4 The most recent documents published by ELAS are the April 15th letter to policyholders and the 2001 Report and Accounts published at the end of April. EMAG has asked me to provide an update to my earlier Report in the light of these events and, in particular, to provide an evaluation of the current state of the with-profits fund.

2. Evaluation of the Current State of the With-Profits Fund of the Equitable Life Assurance Society

2.1 I have been asked to prepare an independent based on the following documents:

- *Equitable Life: The Way Forward*, Equitable Life Assurance Society, 15 April 2002 (by Vanni Treves and Charles Thomson)
- *Equitable Life 2002 and Beyond*, Equitable Life Assurance Society, 15 April 2002 (by Charles Thomson)
- *Annual Report and Accounts 2001*, Equitable Life Assurance Society, April 2002.

2.2 The key points in *Equitable Life: The Way Forward* and *Equitable Life 2002 and Beyond* are:

- Financial management:
 - there is now greater financial stability in the form of a reduced outflow of funds arising from early surrenders and policy maturities: outflows fell from £777m in October 2001 to £237m in March 2002
 - as a result of the need to deliver guaranteed interest rates (GIRs) of 3.5% on policyholders' guaranteed values (75% by value of all policies, but progressively discontinued for those who joined after 1996; see Appendix C), ELAS 'must adopt a cautious bonus and investment policy', which implies that the with-profits fund has to maintain a much higher investment in bonds and a lower investment in equities and property in comparison with other with-profits funds in the short term
 - in the long term, ELAS wants to increase its equity exposure 'to boost investment returns': 'one possibility worthy of examination could be to allow policyholders to opt to swap their existing contract for a new form of contract with higher equity backing. This, of course, would have to be done in a way that did not disadvantage the continuing policyholders who had decided not to change'
 - helping with-profits annuitants, by offering 'to rebase their annuity, so providing a lower income for a number of years and higher income in the longer run'.
- Policy values in future will be shown in both 'guaranteed' and 'indicative' form, where the latter is subject to adjustment according to fund performance and replaces the previous 'accrued' policy value which created a sense of guarantee which was not justified and in 2001 could not eventually be fulfilled. Only GIRs will be added to guaranteed values in future. All other bonuses will be allocated as increases in indicative policy values.
- Bonus strategy: the financial market value adjustment (MVA) on early surrenders and the determination of annual and final bonuses is based on the principle that 'policyholders leaving

the Society do so with no more than their fair share of the assets in the fund and that the interests of continuing policyholders are protected'

- Bonus declarations for 2001 and 2002:
 - as a result of negative investment returns in 2001, the non-guaranteed final bonus for the second six months of 2001 was lowered from 3 to 2%
 - no interim bonus is declared for 2002
- Fair asset shares on policy surrenders or maturity:
 - the MVA applied to surrender values (i.e., non-contractual events) is raised from 10%¹ to 14% for both individual and group schemes ('although the latter will still have a group scheme calculation that could produce a higher percentage adjustment') in order to prevent 'excessive value leaving the fund'
 - the maturity value of a with-profits policy (a contractual event) is reduced by 4%, so long as this is no lower than the guaranteed value of the policy.
- Resolving the issues of the past:
 - ELAS has started legal proceedings against its former auditors Ernst & Young for breach of duty
 - ELAS is trying to identify potentially valid misselling claims from former non-GAR policyholders whose policies matured or were surrendered before the compromise scheme became effective: a valid claim for which compensation would be paid would have to demonstrate both that a loss was incurred and that the policy was missold.
- Moving forward:
 - certain anomalies, such as lower MVAs for group scheme policyholders or the concession of not applying the MVA to policyholders with retirement annuities who switched into a personal pension plan before the age of 60, have been removed
 - ELAS's corporate governance is strengthened through the appointment of two additional non-executive directors and one executive director from 1 May 2002
 - ELAS's articles of association will be reviewed
 - the outsourced administrative service arrangements with the Halifax (now HBoS) will be improved by setting and agreeing specific performance targets

2.3 The key points in *Annual Report and Accounts 2001* are:

- Vanni Treves, ELAS chairman, said: 'It has been a ghastly year for the Society, there is no doubt about that. But because members pulled together to agree an effective compromise, the outlook for the Society is greatly improved, although other challenges still need to be met.'

¹ It had been raised from 7.5% to 10% on 12 September 2001.

- Charles Thomson, ELAS chief executive, said: ‘The 2001 Report and Accounts marks a turbulent year in the long history of the Society but it also provides the opportunity to look to the future. After much hard work, our vitally important compromise scheme is in place. The fundamental uncertainties of GARs have been removed and the financial position of the fund in this Report and Accounts have been improved by £1bn.’
- ELAS spent £36m in 2001 on its Compromise Scheme Proposal to end its £1.06bn liability to GAR (guaranteed annuity rate) policyholders. In total exceptional costs were £153m. Net operating expenses fell from £226.8m in 2000 to £157.9m, largely as a result of the Society’s closure to new business in December 2000. The auditor PricewaterhouseCoopers was paid £8.3m.
- The ‘fund for future appropriations’, which represents amounts available for final bonuses for policyholders in excess of the contractually guaranteed bonuses allowed for in the ‘technical provisions’, fell by £1.1bn to £1.1bn. This was explained by £1.2bn of investment losses (allowing for investment income) (i.e., -6.4%), the payment of final bonuses (£0.9bn), the funding of returns on GIR policies (£0.7bn) and an increase in provisions to pay potential mis-selling claims (£0.6bn). However, the fund for future appropriations improved by £1bn as a result of the CSP (comprising the £250m payment received from Halifax in February 2002 and a £750m release of reserves set aside to cover the cost of the guaranteed annuity policies). It improved by a further £400m as a result of Halifax’s purchase of ELAS’s operational assets in 2001 and by a further £1bn ‘due to an increased discounting of technical provisions’ (i.e., ELAS used a higher interest rate to discount contractual (guaranteed) liabilities to reflect the fact that, on the asset side, the with-profits fund made a substantial switch from low-yielding equities to higher yielding bonds).
- The value of the with-profits fund fell from £25.8bn at the end of 2000 to £18.6bn at the end of 2001 and to £17.6bn by April 2002. This is ‘mainly explained by a drop in market values and withdrawals from the fund’ of around £5.6bn or one quarter of the total.
- The Society’s equity exposure fell from 52% to 25% during the year. The increased bond and cash weighting (needed to meet surrenders and maturities) helped the fund limit its losses from market falls to -6.4%.
- Year-end liabilities for annuities were increased by £150mn to account for improved mortality.
- Since the autumn there had been a ‘significant reduction’ in the outflow of funds through early surrenders and maturities, and the decline had continued this year.
- Total premiums collected during the year had fallen to £1.4bn from £3bn in 2000, as a result of the Society’s closing to new business in December 2000.
- ELAS reiterates its intention ‘not to make additions to discretionary guaranteed benefits’.

- Chairman (Vanni Treves) and chief executive (Charles Thomson) to receive prospective bonuses of £250,000 and £275,000, respectively, on top of remuneration packages of £58,750 and £347,758.
- Fifteen former directors to be sued for breach of duty, including Chris Headdon, former chief executive and former appointed actuary, John Sclater, former chairman, and Alan Nash, former managing director.
- Annual general meeting on 27 May 2002.

2.4 I have the following comments to make on these documents. The *Annual Report and Accounts 2001* is lacking in a number of respects:

- there is no clear statement of the with-profits fund's available assets or any comparison between the available assets and aggregate policy values, where the latter are differentiated between guaranteed and non-guaranteed elements
- there is no statement of whether the available assets are within the range of $\pm 5\%$ of aggregate policy values as indicated in the Appointed Actuary's Report of 22 November 2001
- there is no reporting of the number of members of the with-profits fund at the beginning and end of year.

2.5 Without the £1bn reduction in liabilities 'due to an increased discounting of technical provisions', the fund for future appropriations would have been just £100m. ELAS at present has effectively no fund for 'smoothing returns' or for paying non-guaranteed bonuses. This £1bn reduction is entirely due to the switchover of the fund from being an equity-based fund to being a bond-based fund. Without this switchover, which itself is a sign of a major failure in the investment strategy of the with-profits fund, the £1bn reduction in liabilities would not have been justified, and the fund would have been just £100m short of technical insolvency.

2.6 As James Moore and Antonia Senior reported in *The Times* on 2 May 2002: 'Equitable Life, the troubled insurer, was yesterday described as being "on a financial knife edge" by analysts as it emerged that its actuaries had conjured a £1 billion cushion over insolvency by changing assumptions and suspending guaranteed policy bonuses. The insurer's spare cash, the cushion of assets over liabilities used to pay terminal bonuses when policies mature, fell from £2.3 billion to £1.1 billion over 2001. Without the £1 billion from the actuarial calculations, Equitable would be on the brink of insolvency.....An Equitable spokesman said the move had been made on the advice of Peter Nowell, its appointed actuary. He also said that should its assets fall below liabilities it would, under its articles of association, only have to reduce policy values until the

numbers again added up'. The figures in the *Annual Report and Accounts 2001* indicate that there is only very limited room for manoeuvre in this respect.

2.7 As reported in FT Money – Personal Finance section of the *Financial Times* for 4 May 2002: 'Equitable has changed some of the assumptions used in calculating its figures, which has the effect of reducing liabilities - in this case by about £1bn. Independent analyst Ned Cazalet says: "At the end of 2001, the spare capital not required to cover bonuses would have fallen to £100m without this adjustment - in other words there would have been no spare capital even allowing for the compromise deal." Equitable was able to make the adjustment by moving money out of equities and into fixed interest instruments, which pay a higher income. This income, says Cazalet, can be used either to discount liabilities or to pay annual bonuses. The more you use for the former, the less you have for the latter. "There is no free lunch. If you are using a high proportion of your portfolio yield for discounting purposes, there is very little left over for annual or terminal bonuses. That makes bonus prospects very thin indeed." Equitable has not done anything unusual in making these adjustments to its figures. Life offices feeling the pinch often use this tactic to improve their financial position. But Equitable is sailing closer to the wind than most other life offices and has less room for manoeuvre. "If things got worse, it could probably shift more into fixed interest," says Cazalet. "But that would probably mean markets weren't doing well and Equitable would be forced to sell at poor prices." '

2.8 ELAS has solved a GAR problem only to be faced immediately with a GIR problem. Once again two different classes of investor have been included in the same pooled fund. The non-GIRs now face the same predicament as the non-GARs did before the CSP: the non-GIRs (25% by value of total policyholders) will only be sure of getting a bonus (and then only at maturity) once the GIR's 3.5% annual returns have been allocated in full. Although both GIRs and non-GIRs are currently being awarded the same return, the GIR return is secured, while the non-GIR bonus is not.

2.9 As before in the case of GARs, ELAS offered a guaranteed minimum return to one class of its policyholders and failed to adequately hedge the risks involved. As a result, this risk has been transferred to the non-GIRs who have become unwitting providers of insurance to the GIRs but, again as in the case of non-GARs, have received no compensation for doing so. The insurance takes the form of annual interest rate put options which the non-GIRs have written to the GIRs but without receiving any annual premium from the GIRs. The put options have intrinsic value whenever the annual investment return on the fund falls below the option exercise price of 3.5%.

2.10 In 2001, for example, the return on the fund was –6.4%, but the GIRs were allocated a return of 3.5% on their guaranteed fund, almost 10 percentage points above the actual return. The non-GIRs were also allocated the same return, but in this case the return is only indicative, not guaranteed. Since there are insufficient free assets to justify these allocated returns, ELAS was obliged to raise the MVA on surrenders from 10% to 14% and cut maturity values for all policyholders by 4% (so long as this did not cut into guaranteed values). This is how the interest rate put options are exercised in practice. The 4% cut in maturity values is a completely new form of devaluation in the ELAS with-profits fund. This example also provides a dramatic illustration of why ELAS will never again be in a position to ‘make additions to discretionary guaranteed benefits’. Funds have to kept in reserve for when the put options are exercised again.

2.11 As a consequence of both the low level of free assets and the 3.5% per annum commitment to the GIRs, the future investment flexibility of the with-profits fund is severely constrained. In fact, it will remain a fund heavily dominated by bonds into the foreseeable future if not indefinitely, since the volatility of equity values prevents the fund raising significantly its equity exposure despite the higher long-term returns on equity. This is not at all what any investor, either GIR or non-GIR, believed that they were buying into. However, the promise made by Charles Thomson in *The Times* on 7 January 2002 that ELAS would ‘splash out £4bn on buying shares’ if the compromise scheme was approved seems most unlikely to be delivered.

2.12 The documents illustrate very clearly the lack of transparency that permeates with-profits policies in general and the ELAS with-profits policy in particular. The following examples demonstrate what I mean:

- *The apparent clarity of the term ‘policy values’ creates a false sense of security. It is not an absolute statement of the policy’s worth like a bank or building society statement. ‘Policy value’ is a broad, indicative statement, of necessity subject to adjustment on a policy’s early surrender or on maturity according to fund performance as is the case in other with-profits funds. This year’s annual policy statements will clarify this by showing policy values in ‘guaranteed’ and ‘indicative’ form.*
- *As with any with-profits fund, it is essential that policyholders leaving the Society do so with no more than their fair share of the assets of the fund and that the interests of continuing policyholders are protected.*
- *From now on, in line with other with-profits funds, policyholders wishing to surrender their policies early as well as those proposing to take benefits on maturity will be quoted a ‘surrender value’ or ‘maturity value’ respectively.*

- *These values will be set in accordance with the principle set out above of ensuring that those choosing to leave the fund take no more than their fair share, and adjusted in the light of the circumstances of the fund.*
- *The surrender value will be subject to the financial adjustment set at 14% with effect from 15 April both for individual and group schemes (although the latter will still have a group scheme calculation that could produce a higher percentage adjustment).*
- *The maturity value includes final bonus and reflects that policy's fair share of the fund, which will not necessarily be the same as the indicative policy value. With effect from 15 April the maturity value for a UK pension policyholder choosing to take maturity now will be the indicative policy value calculated allowing for the new bonus announcements, adjusted down by 4%. The maturity value of a policy will not be lower than the guaranteed value of that policy.*
- *As with other with-profits funds the surrender and maturity values will be kept under constant review and the adjustments will change to reflect investment conditions and the strength of the fund.*
- *Continuing policyholders should be reassured that these changes announced today are designed to protect them from the damaging effect of excessive value leaving the fund.*

Far too much is left to the discretion of the appointed actuary to determine critical values such as 'fair share of assets', 'indicative value', 'surrender value' and 'maturity value'.

2.13 How much of this could be ascertained from previous documents sent by ELAS to policyholders? I have re-examined the *Annual Report and Accounts 2000* and the CSP documents sent to policyholders on 6 December 2001 which included the *Interim Report* for 30 June 2001, *Your Question Answered* and the *Scheme Circular*.

2.14 There was nothing in either the *Annual Report and Accounts 2000* or the 6 December documents to indicate that policyholders might be facing insolvency (so long as the CSP was approved). However, the *Interim Report* did provide the following warning: 'The directors have received advice that if liabilities did exceed assets available then the effect of Regulation 4² of the Society's Articles of Association might be to abate the value of policyholder liabilities to the level of available assets. However, the directors are aware that differing legal opinions exist on this issue and that Regulation 4 might not have such effect. In this circumstance, if the directors

² Every policy shall be granted by the Society on the terms that the Society shall only be liable thereunder to the extent of its assets and property from time to time existing, and that no Member of the Society, and no other person who is at any time in any way interested in any policy, shall be liable to any call or contribution, whether in any liquidation of the Society or otherwise howsoever, for satisfying any claim or demand under or in respect of the policy so granted, whether by the grantee thereof or by any other person for the time interested therein.

at any time concluded that the liabilities did exceed the available assets then the Society would be insolvent and would be placed into liquidation in accordance with the Insolvency Act 1985.’ While this statement was clearly intended to apply to the GAR problem, it equally applies to the GIR problem although this was not mentioned.

2.15 There was nothing in either the *Annual Report and Accounts 2000* or the 6 December documents to indicate that policyholders might be facing a GIR problem in future. The *Scheme Circular* does not even mention GIRs in either the Detailed Contents or Key Definitions.

2.16 *Your Question Answered* (p11) states that ‘With a compromise, relative to a position without a compromise, investment flexibility would be improved and the Society could adopt a less conservative bonus policy in the future’. However, this degree of confidence was clearly not followed through to the 15 April documents which warned the current investment inflexibility would remain for some time to come and also ended discretionary guaranteed bonuses. The 4% cut in maturity values has the effect of negating the 2.5% uplift for non-GAR policyholders reaching maturity! This was unavoidable in the light of the investment losses in 2001 and the GIR commitment. However, loyal policyholders have been made worse off by staying. Even worse, given ELAS’s excessive bonus policy in earlier years, policyholders who remain in the fund can expect to face a future of rising MVAs and further cuts in maturity values. If maturity values cannot be cut further without breaching guaranteed values, insolvency will result.

Appendix A: Background

A.1 Between 1957 and 1988, the Equitable Life Assurance Society (ELAS) sold with-profits pension annuities with ‘guaranteed annuity rates’ (GARs) fixed by reference to specific assumptions as to interest rates and life expectancy. The GAR annuities were fixed-rate, single-life annuities. The guaranteed annuity rates were fixed at a level well below the annuity rates available at the time. Since 1988 only non-guaranteed annuity rate (non-GAR) policies have been sold. All premiums arising from both types of policy were invested in ELAS’s with-profits fund. Although the sale of policies with a GAR option ended in 1988, many with-profits policies still offered ‘guaranteed interest rates’ (GIRs), i.e., a guaranteed rate of investment on guaranteed benefits, typically at the rate of 3.5% p.a. for pension policies. Such guarantees were progressively discontinued from 1996 onwards. By mid-2001, 75% of policies by value still had GIRs of 3.5%.

A.2 As of 30 June 2001, there were 70,000 individual with-profits policyholders with GARs (representing 25% of the total value of the with-profits fund) and 415,000 individual with-profits policyholders without GARs (representing 75% of the total value of the with-profits fund). In addition there are 105,000 GAR and 510,000 non-GAR policyholders in group pension schemes.

A.3 In late 1993, open market current annuity rates (CARs) fell below the GAR annuity rates promised by ELAS, thereby raising the cost to ELAS of providing GAR pensions. CARs rose above GARs in 1994, but in 1995 they fell below GARS and have remained below ever since. In addition, the assumptions concerning life expectancy used to determine the size of the GAR pension payments were not revised in the light of improvements in mortality that had taken place since they had been set, further raising the cost of the pensions. The Board at the time did not take these extra costs into account when it awarded annual bonuses and all members’ policy values (both GAR and non-GAR) increased at the same rate.

A.4 However, the Board corrected for the extra cost of the GARs through a ‘differential final bonus policy’ first introduced in 1993 and which it considered was within the discretion it had under Article 65 of the Memorandum and Articles of Association of ELAS. The intention was to declare final bonuses that made the value of total benefits broadly equal to each policyholder’s notional share of the with-profits fund (the ‘asset share’), i.e., the value of the premiums paid increased with investment return and a fair share of any profits and losses to the fund less expenses (subject to a minimum of the guaranteed benefits, i.e., the ‘guaranteed value’). Those policyholders who elected to take the GAR option from ELAS received a lower final bonus than those policyholders who, despite having a GAR option, elected to take their pension benefits in a different form, such as joint-life annuities, but at the

lower market rate ruling at the time. The Board thought that this strategy was legal; the Institute of Actuaries and Treasury Insurance Directorate agreed.

A.5 As a result of complaints from some policyholders who argued that the differential bonus policy rendered the GARs valueless, ELAS initiated a ‘representative action’ in the High Court to resolve the issue (this became known as the Hyman litigation). The case ended up in the House of Lords which ruled on 20 July 2000 that ELAS could not apply a differential bonus policy to any class of policyholder whether GAR or non-GAR. Those GAR policyholders who had exercised their GAR option between January 1994 and 20 July 2000 had to be given the same final bonus as the GAR policyholders who had not taken the GAR option and then the GAR had to be applied to the revised terminal policy value. Crucially the House of Lords also ruled that the cost of meeting the GAR liabilities could not be ‘ring fenced’ within the class of GAR policyholders.

A.6 To illustrate, suppose there are two GAR policyholders each with policy values of £60,000 prior to retirement, asset shares of £100,000 and GARs of 10% when the current annuity rate is 8%. One policyholder decides to take an annuity from a provider other than ELAS and receives a final bonus from ELAS of £40,000. The £100,000 terminal policy value is used to buy an annuity of £8,000 p.a. at the current annuity rate of 8% (for simplicity I assume zero mortality after retirement). The other policyholder chooses to take the GAR annuity from ELAS. ELAS awarded the second policyholder a final bonus of £20,000, implying a terminal policy value of £80,000 and applied the 10% GAR to this, giving an annuity of £8,000 p.a. to this policyholder as well. The cost to ELAS of providing the GAR annuity was £100,000 at the current annuity rate of 8%. So both annuitants received their asset share. However, the House of Lords ruling required both GAR policyholders to have the same terminal policy value of £100,000 and for the 10% GAR to be applied to this value. This resulted in an annuity of £10,000 p.a. and a cost to ELAS of £125,000 at the current annuity rate of 8% (since 8% of £125,000 is £10,000).

A.7 The total cost to ELAS was estimated at the time to be 25% of GAR policy values or £1.5bn, comprising £200mn to cover the lower GAR pension payouts between January 1994 and 20 July 2000 (the ‘rectification scheme’) and £1.3bn for correcting future shortfalls. This sum had to be taken from the single with-profits fund that invested both GAR and non-GAR premiums. As at 20 July 2000, 25% of the with-profits fund represented GAR policyholders’ claims and 75% non-GAR policyholders’ claims. So the House of Lords ruling meant that an ‘economic transfer’ of claims of £1.1bn (75% of £1.5bn) from non-GAR to GAR policyholders had to be implemented.

A.8 In order to both cover and secure the GAR liability and to meet ELAS's statutory capital requirements (the required minimum margin under Section 32 of the 1982 Insurance Companies Act), the Board undertook the following actions. It:

- Set up statutory reserves in respect of the GAR liabilities: these amounted to £1.8bn (net of a reinsurance agreement) at 31 December 2000
- Lowered the 2000 final rate to 3.3% after the retrospective reclaiming of 7 months' bonus
- Retrospectively imposed zero growth for the period 1 January 2000 to 31 July 2001
- Used 'financial market value adjustments' of between 7.5% and 12% to reduce non-contractual payouts on surrendered policies, and
- Switched part of the with-profits fund from equities to bonds.

A.9 During the Autumn of 2000, the Board of ELAS offered to sell ELAS as a going concern to an alternative provider, but could find no organisation willing to inject the necessary capital. On 8 December 2000, ELAS was closed to new business. On 20 December 2000, the Board offered their resignation.

A.10 On 5 February 2001, most of the non-with-profits business of ELAS, along with its infrastructure assets and workforce, was transferred to Halifax plc for £500mn. Other assets were also sold to Liverpool Victoria for £150mn. If, in addition, ELAS is able to resolve the problems in the with-profits fund before 1 March 2002 by means of a 'scheme of arrangement' that caps the GAR liabilities in a way that is fair and reasonable between the various classes of policyholders and preserves the solvency of the with-profits fund, then Halifax will pay a further £250mn (the 'Halifax money') and pay an additional sum up to £250mn if, by 2005, certain business sales and profitability targets are met on the business acquired from ELAS (e.g. sales of Halifax-Equitable policies to the old ELAS client database). There is also a 10-year agreement in place whereby Halifax manages ELAS 'at cost'.

A.11 On 16 July 2001, the Board reduced all policy values by 16% of their 31 December 2000 level. The explanation given was that:

- Asset values in the fund had fallen as a result of falling stock markets since the beginning of 2001 and therefore there was a need to bring policy values into line with asset values
- Many policyholders had taken advantage of the flexible policy terms to retire early with proceeds in excess of asset shares.

The financial market value adjustment was set at 7.5%.

A.12 The Board considered two possibilities for compromising the GAR liabilities:

- A ‘ring-fenced fund scheme’, separate from the with-profits fund, which tops up the asset share of the GAR policyholder on retirement so that any annuity purchased reflects the GAR, with the GAR policyholder having no additional claim on the general with-profits fund.
- A ‘GAR buy-out scheme’, whereby GAR rights are bought out by means of an immediate uplift in policy values.

A.13 The Board rejected the idea of a ring-fenced fund scheme on the grounds that:

- It contravened the spirit of the House of Lords ruling
- It did not place a cap on future costs.

A.14 The Board felt that a GAR buy-out scheme had a number of advantages:

- The capping and crystallising mechanism fixes the cost of GAR benefits
- All with-profits policyholders are treated on the same basis in future
- GAR policyholders who still wished to take their GAR rights and were contractually able to do so (e.g., were over 60) could do so before the scheme came into effect.

A.15 The Compromise Scheme Proposal (CSP) announced on 6 December 2001 is based on a GAR buy-out scheme. The compromise scheme, if it is accepted by a majority of those voting (and by 75% by value of those voting) amongst both GAR and non-GAR policyholders, will be implemented via a scheme of arrangement under Section 425 of the Companies Act 1985.

A.16 The CSP contains an additional proposal, arising from a legal opinion given by Nicholas Warren QC and Thomas Lowe. Warren and Lowe were asked by ELAS whether the House of Lords ruling on ring fencing could be challenged. They advised that this was not possible³. However, they also argued that it was possible that the non-GAR policyholders might have potential claims against ELAS for the potential damage caused by not being informed of the existence and potential impact of GAR rights in policies previously issued by ELAS⁴. The additional proposal in the CSP is that, if it is approved, any

³ The House of Lords ruling would appear to be internally inconsistent. On the one hand, it requires all policyholders to receive the same bonus, but the ruling does not permit the separation of the GAR and non-GAR funds, thereby making it impossible to award GAR and non-GAR policyholders the same bonus. On the other hand, if the reason the GAR and non-GAR bonuses are different is because the GAR and non-GAR policyholders are different classes of investor, then their assets should be in separate funds, thereby violating the House of Lords ruling that the funds of the GAR policyholders cannot be ring-fenced from those of the non-GAR policyholders.

⁴ Legal opinion differed on this question. The Board sought the views of other Counsel, Gabriel Moss QC, David Richards QC, Martin Moore and Barry Isaacs, who did not agree that non-GAR policyholders could recover this type of consequential loss. Further, Ian Glick QC and Richard Snowden, instructed by the Financial Services Authority, were of the opinion that ELAS should only be liable to the extent to which losses of a non-GAR policyholder are attributable to the undisclosed features of the non-GAR policy, namely the GAR risk.

future right to claim damages against ELAS will be waived by both GAR and non-GAR policyholders.

A.17 The Board argued that four principles underpinned its proposed solution. The solution must:

- Be fair to all with-profits policyholder groups
- Be easily understood
- Mean that all policyholders share the pain and benefit of the compromise
- Be able to be implemented.

In addition the proposal must be acceptable to the High Court.

A.18 The Board claims that the CSP satisfies these principles in respect of GAR policyholders since:

- It involves fair value compensation to the GAR policyholders based on a 'realistic estimate' of the value of their legal rights given up that is neither too optimistic nor too cautious
- It apportions the compensation to different GAR policyholders in accordance with their rights
- It reduces that compensation by the value of any possible claim for compensation given up by the non-GAR policyholders
- The compensation takes the form of a proportionate increase in GAR policyholders' policy values in both guaranteed and non-guaranteed form.

A.19 The Board has valued the GAR rights on the basis of the following factors:

- The level of current and future interest rates
- The proportion of benefits taken in GAR form (e.g., exercising the cash lump sum reduces the value of GAR rights)
- The level of future contributions attracting GAR rights
- Future mortality on a unisex basis
- Future transfers out of the fund
- Years to retirement.

The Board has assessed the value of these rights as equivalent to an average 17.5% uplift in policy values, comprising a 16.2% increase in guaranteed benefits and a 1.3% increase in the non-guaranteed policy value arising from the Halifax money if the CSP is approved.

A.20 The apportionment of GAR rights between different classes of GAR policyholder is based on legal rights in terms of the similarity of the interest rate guarantee within each class of policy and on whether there is an option to choose a flexible form of GAR annuity.

A.21 The Board argues that the CSP satisfies the principles in respect of non-GAR policyholders since:

- It involves fair value compensation to the non-GAR policyholders based on the ‘uncertain prospects’ of their potential claims;
- The compensation takes the form of a proportionate increase in non-GAR policyholders’ policy values and an addition to guaranteed benefits to compensate for the guaranteed bonuses that would reasonably be expected in the absence of the House of Lords ruling
- The compensation to non-GAR policyholders should be paid for by a proportionate reduction in the increases to GAR policyholders.

A.22 The Board has valued the non-GAR rights on the basis of the following factors:

- Total potential claims of £850mn (5% of the non-GAR share of the with-profits fund)
- A potential discount of up to 75%, since 75% of the with-profits fund is already owned by non-GAR members
- A potential discount to account for the probability of claims being successful, estimated at between 20% and 70% (however, the Board claims that there is insufficient time to bring a test case before 1 March 2002, the deadline for the receipt of the Halifax £250mn).

The Board has assessed the value of these rights as equivalent to a 2.5% uplift in policy values, comprising a 1.4% increase in guaranteed benefits and a 1.1% increase in the non-guaranteed policy value arising from the Halifax money. The guaranteed values of with-profits pension policies entitled to guaranteed bonuses (including with-profits annuities) will increase by 4% (or by 0.5% for those that have already benefited from a 3.5% increase via a GIR). If the non-GAR policyholders vote for the CSP, they give up potential claims of £850mn in exchange for £220mn compensation, a net transfer of funds to GAR policyholders of £630mn.

A.23 The free assets (i.e., surplus of assets over liabilities) of ELAS are estimated to improve by over £1bn if the CSP is approved (less if the £250mn payable by Halifax is foregone). The Board argues that an increase in free assets will allow greater investment freedom which would permit a greater weighting in equities. However, in the short term, on account of the high level of guarantees currently in the with-profits fund, investment freedom is likely to remain highly restricted.

A.24 In the event of the CSP not being approved at the vote on 11 January 2002, the Board considered the following options:

- Option 1 – Maintain the current position, matching the GAR liabilities with hedging instruments
- Option 2 – Entering bilateral agreements with policyholders

- Option 3 – Apply to the court for a ‘reduction of contracts’ under Section 58 of the Insurance Companies Act 1982
- Option 4 – Make amendments to GAR policies during the course of a Schedule 2C Insurance Companies Act 1982 transfer or a Section 112 Financial Services and Markets Act 2000 transfer of the with-profits business to a third party (including a specially formed company or special purpose vehicle)
- Option 5 – Liquidate ELAS

A.25 The Board decided not to recommend any particular one of these options in the event of rejection of the CSP and it argued that each of them had disadvantages. For example:

- in the case of Option 1 – reserves would have to be set aside both to meet the potential claims of the non-GAR policyholders and to provide a hedge for the GAR liabilities and these reserves would have to be invested in highly liquid fixed-income securities with lower long-term returns than equities
- in the case of Option 2 – the differences of interest between different classes of policyholder or indeed between different policyholders might be so great that policyholders might seek to negotiate individual terms for themselves and this could not be achieved before the 1 March 2002 deadline for receiving the Halifax money
- in the case of Option 3 – unless ELAS was ‘unable to pay its debts’, a court would have no jurisdiction to ‘reduce the amount of the contracts’
- in the case of Option 4 – ELAS has been advised that there is ‘no absolute certainty’ that the court would approve amendments made under these Acts
- in the case of Option 5 – it would be expensive (‘possibly over £100mn’) and is unlikely to benefit policyholders unless it incorporates a compromise solution to the GAR problem

A.26 In the event of the CSP being rejected, ELAS would have to continue to reserve against GAR liabilities and this would constrain investment freedom not only in the short term but also in the long term, as well as making the financial position of ELAS much harder to manage. To maximise the certainty of cash flow, a very high proportion of the fund’s assets would have to be held in bonds, rather than equities. Future investment return can therefore be expected to be ‘modest’ until retirement or throughout retirement if a with-profits annuity is taken. Those taking ELAS annuities would be receiving a pension from a provider with a ‘very low credit rating’. The ELAS bonus policy would be based on prudence, i.e., only to pay out contractual amounts as they fall due without any non-guaranteed bonuses being paid. Surrender values would reflect only contractually guaranteed amounts (converted from the earliest maturity date to a present value).

A.27 According to the Appointed Actuary (Report, 22 November 2001, p13, and repeated in the *Scheme Circular*, p104), 'it would only be through action of this nature that the Society could build up significant assets to meet potential legal claims beyond the provisions made. The unfortunate implication of doing so would be to depress payouts for some policyholders, emphasising the inevitable problems in maintaining equity between different groups. The Society's priority would have to be to meet the competing demands of legal claims and paying guaranteed benefits as they become due. Payment of non-guaranteed benefits would be much more uncertain, at least in the short term. The prospects of any discretionary guaranteed benefits would remain remote because of the need to meet the 3.5% GIR, and the already high levels of guaranteed funds'.

A.28 The Independent Actuary, appointed by the Board to consider the 'reasonableness and appropriateness of the actuarial assumptions, valuations and methodologies used by the Society in developing the Scheme and the reasonableness and fairness of the terms of the Scheme (i.e., the CSP) from an actuarial point of view', concluded that 'from an actuarial point of view the terms of the Scheme have been established in a fair and reasonable way' (p43) and that the 'Society has established the GAR cost on a realistic estimate basis' (p18) and warns 'in the event that the Scheme is not implemented, a full reappraisal of the asset mix would be required to establish a long-term stable investment mix which recognises that the GAR problem will be likely to persist throughout the lifetimes of remaining policies' (p8) and as a result will 'cause an unsatisfactory solvency position to persist for the Society' (p10).

A.29 On 28 January 2002, there is a massive vote by policyholders in favour of the CSP, ranging from 97% to 99% by number and value. At 13.42hrs on 8 February 2002, the High Court sanctions the CPS. Immediately ELAS applies the 10% final market value adjustment (i.e., exit penalty) on all non-contractual events, such as (now former) GAR policyholders switching to another provider between the ages of 50 and 60; previously such a move had not been penalised (a switch after the age of 60 would be a contractual event and hence not subject to the MVA). ELAS receives the remaining £250mn of the Halifax money as specified in the CSP. In April 2002, ELAS cut the maturity values of its with-profits policies by 4% and raised the MVA from 10 to 14%.

A. 30 In the 2001 Report and Accounts published in April 2002, ELAS proposed to make large bonuses for its chairman and chief executive; although at the time of writing the bonuses had not been confirmed. Charles Thomson, who became chief executive in March 2001, was given a bonus of £275,000 in addition to his total remuneration package of £347,758 for the year to December 2001. Vanni Treves, who took over as ELAS chairman in February 2001, was given a bonus of £250,000 in addition to his remuneration of £58,750.

A.31 There are a number of ongoing enquiries in connection with this case:

- Herbert Smith – Herbert Smith, the solicitors, were instructed by the present Board to investigate whether there are any causes of action against former directors, appointed actuaries, auditors, legal advisers or regulators. In April 2002, ELAS announced that it was going to sue its former auditors Ernst & Young for £2.6bn and 15 former directors for £3bn for breach of duty. Vanni Treves, chairman of ELAS, said: ‘The actions or inactions of these former directors caused many policyholders substantial loss of benefits’. ELAS claimed that the former directors failed to obtain legal advice on the policy of paying lower bonuses to policyholders with guarantees and that, once the Hyman litigation was underway, the directors failed to act on the advice that ELAS might lose and make adequate financial provision. ELAS claims that Ernst & Young failed to make provisions for guaranteed annuity liabilities in ELAS’s statutory accounts for 1997-9. ELAS was advised that it had no case against its former lawyers, Denton Wilde Sapte.
- Penrose – Lord Penrose has been asked by the government to chair an inquiry into the affairs of ELAS; on 16 October 2001, Ronnie Baird, Director of Quality Assurance and Internal Audit at the Financial Services Authority, published a report on the Financial Services Authority’s role in regulating ELAS between 1 January 1999 and 8 December 2000 which has been submitted as evidence to the Penrose inquiry. ELAS has said that it would wait to see the findings of the Penrose enquiry before deciding whether to take legal action against its regulator, the Financial Services Authority.
- Parliamentary Ombudsman – The Parliamentary Ombudsman has instituted enquiries in relation to the Financial Services Authority’s role as regulator of ELAS
- Treasury Select Committee – Subsequent to its Interim Report on Equitable Life and the Life Assurance Industry of 10 March 2001, the Treasury Select Committee will report to the House of Commons on the ‘key factors explaining its [Equitable’s] recent problems’.

Appendix B: Documents used in this Evaluation

Proposed Compromise: Ready for Your Comments, Equitable Life Assurance Society, September 2001.

Background to the Proposed Compromise, Equitable Life Assurance Society, September 2001.

Scheme Circular, Equitable Life Assurance Society, December 2001.

Your Questions Answered, Equitable Life Assurance Society, December 2001.

Interim Report for the Half Year Ended 30 June 2001.

Report of the Appointed Actuary of the Equitable Life Assurance Society on the Proposed Scheme of Arrangement under Section 425 Companies Act 1985, 22 November 2001.

Report of the Independent Actuary on the Proposed Scheme of Arrangement under Section 425 Companies Act 1985, November 2001.

Equitable Life: The Way Forward and Equitable Life 2002 and Beyond, Equitable Life Assurance Society, 15 April 2002.

Annual Report and Accounts 2001, Equitable Life Assurance Society, April 2002.

Annual Report and Accounts 2000, Equitable Life Assurance Society, April 2001.

An Assessment of the Adequacy and Objectivity of the Information Provided by the Board of the Equitable Life Assurance Society in Connection with the Compromise Scheme Proposal of 6 December 2001, David Blake for EMAG, 19 December 2001 (updated 28 December 2001) (This report is available at: http://www.pensions-institute.org/reports/equitabliflife_DBreport.pdf and <http://www.emag.org.uk>)

Appendix C: Contractual Terms used in relation to Benefits and Policy Values of the Equitable Life With-Profits Personal Pension Plan

Pension Product Particulars PP(PP)9.90

Benefits□	“The benefits are provided on a money purchase basis building up a fund...” “The full value of the funds accrued is available to provide benefits.”
Interest	“Earnings on the invested assets... are passed onto policyholders by way of guaranteed interest and bonuses of various kinds. The policy guarantees a minimum rate of interest of 3.5% per annum compounded up to the date that benefits are taken.”
Bonuses Declared	“Each year, bonuses are declared by the Directors, on the advice of the Appointed Actuary, following his valuation of the Society’s assets and liabilities, using the powers given by the Society’s Articles of Association. These bonuses, once allotted, themselves become guaranteed additions to the contracts.”
Final share of profits	“A final share of profits is also allotted at the point the benefits become contractually payable.”
Smoothing out fluctuations	“They [the Society’s with-profits contracts] have the essential feature of smoothing out fluctuations in earnings and asset values generally associated with investment in such portfolios.”

Personal Pension Plan Policy number V0156328 dated 5 April 1991

Benefits	“the Society agrees to pay the benefits secured by this Policy which will be calculated paid and applied in the manner described in the [Equitable Personal Pension Plan Policy March 1990] Booklet.”
----------	---

The Equitable Personal Pension Plan Policy Booklet (March 1990)

Benefits (page 5)	Sec 3: “All benefits shall be paid to the Scheme Administrator to be applied solely in accordance with the rules”
Sum Assured (page 7)	Sec 5.1(a): “The Sum Assured secured by a With-Profits Segment shall be a variable sum equal at any particular date to 95.5% of the total of the premiums which have been attributed to such Segment each such premium having first been increased by compound interest at the rate of 3.5% per annum calculated from the date of payment of such premium to the said particular date with yearly resets”
Related Bonuses (page 7)	Sec 5.2(b): “Related Bonuses are also variable and will be calculated by the Actuary at any particular date in accordance with the rules and regulations of the Society”
Participation in Profits (page 7)	Sec 5.3: “The Policy shall confer a right to participation in the profits of the Society in respect of the Sum Assured secured by a With-Profits Segment ... until the date upon which the said Sum Assured ... has become payable”

Appendix D: About the Author of this Report

Dr David Blake is Professor of Financial Economics at Birkbeck College in the University of London and Chairman of Square Mile Consultants, a training and research consultancy. Senior Research Associate, Financial Markets Group, London School of Economics. Senior Consultant, UBS Pensions Research Centre, London School of Economics. Research Associate, Centre for Risk & Insurance Studies, University of Nottingham Business School. Formerly Director of the Securities Industry Programme at City University Business School and Research Fellow at both the London Business School and the London School of Economics. Consultant to many organisations, including Merrill Lynch, Deutsche Bank, Union Bank of Switzerland, Paribas Capital Markets, McKinsey & Co., Financial Research Services Ltd, James Capel, Schroders, Browne Jacobson Solicitors, Finers Stephens Innocent Solicitors, Taunton Cider Company, Hill and Knowlton, the Independent Television Companies Association, the Office of Fair Trading, UNESCO and the World Bank.. External Examiner for the Wholesale Markets Brokers Association Diploma. Registered as an Approved Person with the Financial Services Authority.

David Blake was a student at the London School of Economics in the 1970s and early 1980s, gaining his PhD on UK pension fund investment behaviour in 1986. His research interests include the modelling of asset demands and financial innovations, the investment behaviour and performance of pension funds and mutual funds, and pension plan design. He has published in major economics and finance journals in all these fields. He is author of *Financial Market Analysis* published by Wiley in 2000, *A Short Course of Economics* published by McGraw Hill in 1993, *Modelling Pension Fund Investment Behaviour* and *Issues in Pension Funding* both published by Routledge in 1992, and *Pension Schemes and Pension Funds in the United Kingdom* published by Oxford University Press in 1995. Professor Blake gave evidence to the Goode Committee in March 1993 and was a member of the Retirement Income Working Party which published its report *Improving Security and Flexibility in Retirement* in March 2000.

In June 1996, he established the Pensions Institute at Birkbeck College. The Pensions Institute undertakes high quality research on all pension-related issues and publishes details of its research activities on the internet (<http://www.pensions-institute.org>). The Pensions Institute was the first academic research centre devoted exclusively to studying pensions matters to be established outside the US.

David Blake regularly speaks at international conferences on pensions and pension fund management in the UK, Europe, the Far East, Australia and the Americas.

The author is not a member of the Equitable Life Assurance Society.