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Sir John Chadwick
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Dear Sir John,

Comparators – Your Letter of 30th October

In my letter of 12 October I set out what I considered to be strong general arguments for creating the "Ideal Comparator" by using a 'modelling' approach to determine how policyholders at Equitable Life ought to have been rewarded as opposed to the ways in which they actually benefited or failed to benefit. I also provided illustrative results of applying such methods over the period 1-1-1975 to 1-1-2001, using the information that has so far escaped into the public domain.

In your letter of 30th October you set out your doubts regarding the applicability of such methods to your own assignment, and I must thank you for the care and precision with which this has been done, which have caused me to look again at the basis for my own proposal. In general I stand by everything that was advanced in that original letter, which indeed needs to be read in conjunction with this.

It may be helpful to tackle the question in two stages:

1. **When, if ever, is such modelling appropriate in determining notional losses in cases of financial failure?**

2. **Assuming that the case of Equitable Life meets the criteria established in (1), is the approach nevertheless better or worse than using a comparator (or comparators) based on the reported performance of some mix of competing products?**

Why and When Is Self-Modelling Needed?

Strictly speaking, all forms of comparator suggested for this purpose are varieties of modelling. What we are discussing is the pros and cons of an internal self-model based on Equitable's actual growth rates and bonuses, versus an external model based on the bonuses of some basket of competitors.

I assume that there is no need now to demonstrate yet again that there were losses incurred by people saving for their retirement through the medium of Equitable pension and life policies. But the problem is that we have no agreed measure of who lost and by how much.

As far as I am aware, Penrose discussed only the <u>minimum</u> sum of money which the Society would have needed to remain a going concern under its established and dangerous actuarial conventions, while the Parliamentary Ombudsman declined to investigate the issue, passing the responsibility on to a proposed 'Tribunal'. You Sir John now stand 'in loco tribunalis', which some of us accept while others, principally those affiliated to EMAG, continue to contest the arrangement for the present.

The need for sophisticated modelling derives from the way in which the losses and gains were generated. They developed incrementally over the years as excessive bonuses were awarded and claimants exercised their nominal rights, but took out more, on average, than their proper share of the assets. So, the assets that remained were inadequate to meet the Reasonable Expectations of the policyholders still in the fund.

This was fully visible to the Regulators, but only to them or others similarly skilled in actuarial methods. Officially, they ignored or overlooked the fundamental problems. The overall effect, as mentioned in my earlier letter, is that some policyholders benefited, while many more lost out, and of those who lost, the proportionate losses varied widely.

This contrasts with the more common situation in which losses are generated over a short period of time, either by inappropriate investment policies or by outright fraud or theft involving third parties. In this latter 'short–term' situation the loss can be allocated pro rata to investors' holdings, subject to any guarantees applying to different classes of investor, and no case by case modelling is needed.

Having demonstrated the 'obvious', albeit at some length, the question then arises of <u>when is the self-model superior to the 'basket of competitors' model?</u> The general axiom is that the self-model is always superior, provided that it can be set up so as to incorporate the errors that were made and also the most reasonable corrections to those errors. The self-model must meet tougher criteria than the basket model, in that it must reproduce both the details of the failure in its 'historic' formulation, and the details of the 'cure' in its comparator formulation. Although the basket model claims only to do the latter, that claim is poorly supported for a variety of reasons discussed below. **[see page 4]**

In effect, the comparison between the self-model and the basket model is one between facts and appearances. Any forensic investigator would choose to use the self-model wherever he could, as the proper means of understanding and explaining the problems. He knows that if he were to go into court saying "*this amount was lost by each class of depositor in comparison with what other businesses made, but I cannot tell you how*", he would be held up to scorn.

A useful analogue is to be found in US bankruptcy practice for investment accounts where the concept of "Net Equity" is applied to each investor account. Under this approach, the notified balance is disregarded and replaced by the balance of all *legitimate transactions*, for both securities and money. The liquidator is required to go back in time reversing all fraudulent or erroneous transactions for every account holder to arrive at a total of *preferential claims* which may qualify for payout under the Industry Guarantee Scheme.[1]

In a case where there had been, as with Equitable Life, substantial over-allocation, then the excessive part of each allocation would have to be reversed to arrive at the *Net Equity* in each account. Industry comparisons would not be regarded as acceptable for this purpose. The proposed Ideal Comparator follows a very similar approach, but in addition it also corrects for any subsequent under-allocations on a consistent basis. In sum, our proposal would not be regarded as in any way new in an American context.

As you will appreciate from the example given in the earlier letter, I do speak from direct personal knowledge of the application of such self-modelling techniques to the matter in hand. In 2001 I warned the Treasury (via Rudi Vis MP) that Equitable appeared to be close to insolvency[2], only to discover some eight years later that Mr Treves had anticipated me by a couple of months at most.

In 2002 I used crude modelling techniques to estimate the realistic asset shortfall over the period 1989-2000, and when the Society's own figures were disclosed in Penrose, found that I had been only 5% out in total.[3]

Subsequently I refined the models as more data became available to me from earlier Insurance Returns, and was able to demonstrate that the detailed descriptive narrative in Penrose was remarkably correct, whereas many of the summary quantities in his appendices were wide of the mark.[4] The work was extraordinarily challenging because I lacked access to the Society's internal underwriting book as well as explanations of the actuarial methods underlying the various figures in the returns.

Nevertheless, I was able to pinpoint where and how over-allocation had occurred, and when this over-allocation had begun to seriously impact the asset situation, together with various other related issues bearing on the gains and losses of particular classes of policyholder. A particularly interesting outcome was that there are unexplained discrepancies in the returns for the years 1985-1991 that were never addressed by the Regulators. One must assume that your actuarial advisors who would have full access to the underwriting records at a

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[1] Interestingly, in the Madoff liquidation, the Federal Courts have ruled that all reported transactions were fraudulent, which is a rather extreme example!

[2] Copies of the relevant letters are still available

[3] Letter from Investors Association to Lord Penrose

[4] For example, rates of Terminal Bonus were around 140% in error for the period 1975-1988, being quoted as 3% when the correct rates were in excess of 7%. More seriously Penrose thought that the 'Office Account' was at 'face value', whereas in fact it was actuarially shrunk and understated the asset shortages in every year.

proper level of detail, enabling them to construct such a model in an altogether more reliable and satisfactory way.

On the basis of the work that I have done, I have no doubt whatsoever that you would find such a professionally constructed model of inestimable use in formulating and justifying your eventual advice to the Treasury, even if your factual conclusions (regarding who did and did not sustain losses) might not necessarily be welcome to those who have made it their business to obfuscate the chains of responsibility these last ten years.

Special Advantages for an External Model in this Case

In objective terms there are no special advantages for an external (basket) model in this case. The trail of mismanagement is essentially simple and consisted of allocating literally unsustainable levels of bonus over a period of many years, and doing so in a manner incompatible with Mutuality. Any alternative bonus policy that was a) sustainable, b) fair and c) consistent with asset preservation vis-à-vis PRE would provide an acceptable comparator. Although I cannot prove it, I am confident that an optimal comparator would emerge from rational analysis of the remaining choices that would have been open to a management operating in the way that the Society claimed to operate. [i] [see endnote]

There are of course some formal disadvantages in using a concept which was not publicly considered prior to my letter to you of 12th October. Since you have set them out in your response, I have covered them in my detailed comments on your letter.

There are however some specific disadvantages to the use of basket comparators in this case. These are some of them; (the list is by no means exhaustive):

1. For proper comparison, the competitor needs to have operated over at least the crucial period for Equitable Life, i.e. 1980 – 2001. However, we understand that at least 25 of Equitable's competitors closed to new business within that period, many of them substantial firms, seriously reducing the pool of remaining competitors.

2. Equitable was a mutual, non-commission paying house. To compare it with Life Assurers who paid heavy commissions to intermediaries and were shareholder oriented creates further serious problems.

3. Equitable conducted approximately 90% of its business in the pensions field, with a very significant hold on the AVC market. Any comparator firms should have averaged at least 60% pensions within their product mix, of which at least 20% should have been unit-linked and 20% group schemes.

4. Many of the residue of competitors are 'minnows' statistically as compared with Equitable. Their performance would either need to be excluded or weighted by turnover which would amount to very much the

same thing. For any firm included in the 'basket' it would be necessary to prove that they were not tainted by the sorts of regulatory failure that allowed Equitable to collapse.

5. **Statistical comparison where the relevant pool is dominated by a few large players almost always produces results that are subject to selection bias of one sort or another.**

6. **Such selection bias has already been exhibited in various proposals emerging from the EGP Process, such as weighting the sample towards those houses with a conservative investment policy. ELTA wish to have a sample of one (the Prudential), while EMAG will have their own well researched ideas.[ii] [See endnote]**

Specific Points in Sir John's Letter

[The paragraphs from the letter are quoted verbatim, but sub-references a), b) …. have been inserted for ease of cross reference.]

a) *First, my Terms of Reference expressly require me to consider "relative losses". It seems clear that this means losses measured by reference to the position in which policyholders could have expected to be if they had invested elsewhere than in Equitable Life. I have in mind, in particular, paragraphs 1/14/29-42 (pages 381-382) of the Ombudsman's Report. It seems to me that the effect of these paragraphs is to rule out an approach based on absolute loss, however that might be measured.*

<u>Response to a):</u> I am confident that the Ombudsman used the term 'relative loss' to distinguish her approach from those who argued that the comparison should be with individual policy values as at 1st January 2001 or similar reference date, irrespective of whether or not the policyholder had made gains or losses up to that point. She refers to that as an estimate of "Absolute Loss". All Comparator approaches discussed between us are "Relative Loss" approaches in the sense with which that term is used in the Ombudsman's Report. The Ideal Comparator proposed is, of course, a relative loss method, as it would show many policyholders as having made a net gain. It is a fact that no one proposed the self-comparator method to her[5], and she was therefore unaware of the possibility of using it. The debased 'market comparator' was her only ready-to-hand option when she wished to make a concrete suggestion.

b) *Second, I do not find self-evident the point you make at page 2: to the effect that measuring loss against a basket of comparators "is not robust, being*

[5] I was surprised to see such an explicit methodology put forward in her Final Report, as it seemed to me to be a proper matter for the 'Tribunal' to consider, as we are now doing.

inherently contentious and depending too much on the opinions of [my] Actuarial Advisors".

<u>Response to b):</u> One over-riding consideration is the need to exclude any competitor whose Estate was allowed by the regulators to fall below reasonable levels of adequacy. Otherwise the regulatory failure which allowed Equitable to be destroyed as a viable Life Company, would contaminate the comparator sample as well as Equitable itself. This would become a highly contentious matter. In addition there are the general selection problems referred to under Special Advantages for an External Model in this Case **above. Surely it is vital that all parties have confidence that your conclusions and the scheme as a whole pass the test of reasonableness, and that it wins the support of "the man on the Clapham omnibus!"**

c) *Rather, as it seems to me, an approach which sought to replicate the manner in which Equitable Life "should" have managed its business might be seen to be at least as, if not more, open to debate and dependent on the judgment of my actuarial advisers. But that does not, of course, rule it out.*

d) *The approach that you have proposed would require decisions **<u>as to how Equitable Life should have distributed its assets as between different classes and different generations of policyholders.</u>** This must be purely a question of actuarial judgment. I doubt if policyholders would find it easy to understand the basis on which any such decisions were made. I therefore disagree with your statement at the bottom of page 3, that your proposed approach would: "provide clear and succinct explanations to each policyholder as to how their losses and gains have been determined, and therefore why so many of them must perforce be excluded from any payment scheme."*

Response to c) & d): Stated in general terms, the underlined passage makes it all seem very difficult. But the reverse is the case. First of all, the decision/s are essentially business judgments to be taken by yourself, based on broad contractual considerations, and on what the policyholders signed up for. These were typically

i. **Business to be run as a going concern for the long term, not sold off for the benefit of carpetbaggers**
ii. **Assets to cover stated policy values**
iii. **Smoothing of bonuses to reduce short term ups and downs**
iv. **Fair treatment between different types and cohorts of policy.**
v. **A total avoidance of *Negative Estates***

Your advisors would have the task of turning your decisions into sensible numerical parameters, which would scarcely stretch their capabilities unless they tried to achieve irrelevant levels of accuracy for the purpose.

Very few policyholders would openly object to these, even if they had in fact expected special treatment and unfair bonuses. Given these assumptions everything else that matters follows readily. The objections are more likely to

take the form: "*then in that case I would have got out in 1992 (or similar)*". The answer to which is to point out that one must assume that everyone else would have done the same and the Society would have folded before they could leave.

It would not be at all difficult to get policyholders to understand what was being proposed as a Comparator, (those still capable of following a logical exposition). Even those approaching senility would see the logic in not giving a payment to those who had done well at the expense of everyone else. The idea that the Government subvention was needed to cover the overpayments that were no longer recoverable would also make sense to *Mr Average.*

e) By contrast, an approach based on market comparators is, at least, easy to comprehend. It may be that some policyholders will disagree with whatever determination is made in relation to the appropriate comparator. However, it will at all stages be clear what decisions are being made; and policyholders will have had the opportunity to make representations in relation to a scheme that is as comprehensible as possible.

Response to e): I think that I have made a case that, with real historic primary data and the selection of forensically important parameters, the self-comparator is generically superior to the market comparator approach. Even so, I would accept that, in the present context, my proposal seems new, while the other seems plausibly familiar, while being in reality seriously flawed. As American investment legislators came to see, the self-comparator is the only satisfactory basis when Billions of public money are involved.

Yours sincerely

Michael Josephs

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[i] JC 18/11/09: "In general, I note the points you make in support of the use of a notional comparator. I have not yet reached a definitive view on the question as to what kind of comparator should be used. However, I still tend to the view that a notional comparator is likely to prove more contentious and less readily understood than a basket of actual comparators. "

[ii] JC 18/11/09: " You urge that I should avoid using comparators that were not affected by maladministration of the same kind as Equitable Life. But I do not understand how you suggest that I should identify those comparators which were (or might have been) affected by maladministration. My Terms of Reference do not permit me to investigate whether and, if so, where and when, maladministration occurred in relation to other participants in the life assurance industry. "