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Sir John Chadwick
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Dear Sir John,

Calculation of Individual Losses – An Ideal Comparator

I thank you for your letter of 1st October in response to mine of 16th September. It has generated much interest on the part of my colleagues, especially regarding the distinctions that you draw between matters predetermined by your Terms of Reference and other matters on which you have formed provisional views of your own.

There are a number of significant areas where the perceptions of policyholder advocates will differ from those that you have expressed, and I think that it would be helpful to advise you of those issues, even if, in the end, the differences cannot be resolved. However, I propose to defer all but one subject area to a later letter, in order to address the issue of "The Comparator", which seems to us to be of central importance.

It does in fact bear upon the comments that you have made under references '5.C, 5.D and 5.J', and the fuller interpretation in your Interim Report which reads as follows:

"One major consideration that I have identified is whether the appropriate comparator should be modelled by reference to the best, median or most poorly performing life offices over the period. This consideration is likely to be influenced by the fact that Equitable Life's business was carried on pursuant to a policy of full distribution. This fact was known to all policyholders, or would have been known to any who made the most rudimentary inquiry into the life assurance industry. In creating a model based on data from other life offices, it seems to me that it may be appropriate to assume that the comparator would have adopted a similar policy of full distribution. I currently take the view that if a life office were to operate a policy of full distribution responsibly, it would adopt a conservative approach to investments. That would be reflected in the assumptions to be made as to yield and growth of the fund. I invite comment on these points."

As a precursor to the detailed suggestion that I am advancing, I attach a submission from myself to the EQUI Committee of the European Parliament, and entitled "Fraud and Failure" which is already in the public domain, having been published by them nearly three years ago in November 2006. Equitable Life chose not to respond to the paper and have never to my knowledge addressed the arguments it puts forward. I regret that it is so long, but on re-

Comment: Not attached in this version. See http://www.europarl.europa.eu/comparl/tempcom/equi/written_evidence/20061120_investors_assoc_en.pdf

examination there is little that could be cut out without destroying the integrity of the argument.

I am not asking you to agree that all its conclusions are correct, but to take note that there is an arguable case for the following, which are supported by evidence both in the Annual Returns and in Lord Penrose's Report:

a) **That nearly all policyholders' losses derived from the overbonusing of earlier cohorts of policyholders; hence one policyholder's loss is another's gain.**

b) **That insufficient assets were retained from 1985 onwards to support a policy of "Full and Fair Distribution"**

c) **that key Officials of the Society were fully aware of this, and were deliberately deceptive in claiming that they were following such a policy, as well as claiming that individual's Policy Values were equivalent to their "Smoothed Asset Shares"**

In your Interim Report you propose to follow a 'Comparator Strategy', using the performance of a basket of other with-profits providers to provide comparative return figures for the whole period of each policy, or for as much of that period as you have reliable computerised data.

While I do agree with the broad concept, I believe that you have chosen the wrong form of comparator, because the BOC (Basket of Competitors) concept is is <u>not robust</u>, being inherently contentious and depending too much on the <u>opinions</u> of your Actuarial Advisors, and it is also seriously confounded by the regulatory failures that occurred at competitor life companies. In addition, its subjectivity is certain to arouse suspicions of unfair dealing, whether or not such suspicions are justified.

May I offer an example from my personal experience: In 2002 Standard Life was thought to be financially strong and I compared its finances with those of ELAS. My conclusion was that despite a significantly better solvency ratio, it was more exposed to terminal bonus commitments and was not a good investment. Shortly thereafter it had to demutualise and rationalise its business under strong pressure from the FSA. But most insurance people would have included Standard Life in the upper quartile of performers, despite the huge amounts of commission it paid away from policyholders' accounts.

It is my understanding of your letter that you wish to propose a payment scheme that will provide a workable framework no matter what the outcome of the imminent judicial review (and possible appeals), any political moves within the current Parliament or any new approaches that may emerge after the next election. For that to be achieved, the calculation of losses would need to be

1. **As objective as possible, and on an individual not collective basis;**
2. **Completely separate from any discounting for shared responsibility;**

3. Separate from any further restrictions applied for 'Public Purse' reasons.

This is readily achievable without reference to the performance of other life companies because the source of nearly all of the losses was the failure to conserve an adequate estate compounded by the award of excessive bonuses for the years 1975 to 1990. Of course, the excessive bonuses and the lack of an estate were closely interconnected.. In other words, Equitable's monies were not on the whole spirited away for the benefit of outsiders (as far as anyone has been able to establish), but they were paid out far too generously to policies of earlier vintage leaving an ongoing deficiency for those which remained.

The overall picture of these excessive bonuses and resultant asset deficiencies can be reconstructed from the Annual Insurance Returns in broad-brush form, and I have been able to do this, but only by making many detailed assumptions because of lack of access to the source data.

Even so, I am quite confident that, working with Equitable's original summarised source data, your actuaries could rapidly construct a robust model of premiums received, bonuses awarded and claims paid out for each principal class of WP business, and that this model would show the extent of overbonusing in each year and by how much the asset position would have improved had bonuses been awarded on a 'sound and prudent' basis.

Such a model depends primarily on what is considered a 'prudent' level of asset cover, and my simple answer is that the assets should at least cover the cumulative policy values as they were notified to investors, i.e. that there must be no element of actuarial shrinkage involved in the calculation of minimal asset cover, quite independently of what is shown as the mathematical reserves for the Solvency calculations. However, I do not wish to imply that the comparative level of asset cover in the model is a trivial decision. On the contrary it is a strategic issue which needs to be carefully examined, along with several other 'parameters'.

It is debateable whether a further provision for 'smoothing' is required in addition to covering the full policy values. If the Society wishes to award higher bonuses in a given year than are justified by the asset position then there should indeed be an additional smoothing reserve. Provided the rules are applied consistently an excessive bonus or poor return in one year will be compensated by lower bonus or better return in the following years, as long there is no assumption <u>about the future being better than current experience</u>.

Such a model, incorporating sound and prudent levels of bonus, provides the robust "Comparator" which your scheme requires, but it has two other inestimable advantages:- (i) it provides clear and succinct explanations to each policyholder as to how their losses *<u>and gains</u>* have been determined, and therefore why so many of them must perforce be excluded from any payment scheme; and (ii) it provides a consistent pro rata <u>asset adjustment</u> which represents the value of any 'future losses' for policies like WPAs which have not

yet been crystallised. This latter feature is not readily available in the other forms of Comparator.

You will want to know the scale of the bonus adjustments which my own particular model indicates to be necessary. The answer is relatively simple:

- a **For the period 1975 to 1989 each year's total bonus would need to be reduced by 30% of what was eventually[1] awarded, thereby bringing assets and policy values into line by the end of 1989. [It could be argued that such a rapid correction was unduly stringent, but the general concept is sound]**

- b **For the period 1990 to 1994 inclusive there need be no change to the bonuses actually awarded.**

- c **For the period 1995 to 2000 total bonuses should have been 20% higher each year, to avoid the creation of an excessive estate, (but perhaps some additional estate would have been prudent given the large additional provisions brought into account in 2001-3).**

- d **After 2000, the business would have functioned normally despite the GAR issue. There would have been no closure and probably no resort to the Courts. Bonuses would have reduced progressively in line with the general decline in investment returns, but there would have been no need for policy cuts or similar emergency measures.[2]**

For any such model to be a valid "Comparator" it should be based on the following general assumptions:

1. **Contracts and premiums would be unaltered;**
2. **Inception, payment and redemption dates would be unaltered;**
3. **Policy Values are those notified to policyholders, but modified by any adjustments to bonus;**
4. **Claims increase or decrease in line with total policy values**
5. **Assets increase or decrease in the opposite way to claims, but they are also adjusted upwards by the increased return on a larger asset pool (and vice versa).**

In the following tables, I summarise the outcome of my own specific model which breaks the history of the Society into three separate time periods, each with its own level of bonus adjustment. Table 1 summarises the historic situation culminating in substantial asset shortages in all three periods. Table 2, representing the Full and Fair model, shows how the reduction in bonus levels in the first period would have brought the whole asset situation into balance, and maintained that balance through to the end of year 2000.

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[1] Guaranteed bonuses were fixed once awarded, but up to 1988 Final Bonuses were increased retrospectively, thereby heavily favouring the earlier policies.

[2] I have not attempted detailed computations of the post-2000 scenario because the details would depend on the precise assumptions made. But the realistic asset margin at the end of 2000 would have been around 10 Billion stronger than it was in fact. Correspondingly GAR policies would have been carrying much lower values than they did in practice.

Statistic	Historical Version (values in millions) 1975-89	1990-94	1995-2000
Average Uplift	17.0%	11.4%	9.8%
Premiums	£3,045	£6,706	£14,557
Policy Values Increase	£7,497	£9,098	£16,048
Claims	-£1,289	-£3,847	-£11,418
Assets Increase	£4,812	£5,896	£15,027
Realistic Margin	-£2,936	-£6,138	-£7,159

Table 1 Historic Bonuses and Assets

Statistic	Sound and Prudent Model ("Full and Fair") (values in millions) 1975-89	1990-94	1995-2000
Average Uplift	11.9%	11.4%	11.7%
% change from Historical	-30.0%	0.0%	20.0%
Premiums	£3,045	£6,706	£14,557
% change from Historical	0.0%	0.0%	0.0%
Policy Values Increase	£4,973	£8,604	£18,355
% change from Historical	-33.7%	-5.4%	14.4%
Claims	-£896	-£2,884	-£10,392
% change from Historical	-30.5%	-25.0%	-9.0%
Assets Increase	£5,556	£7,911	£18,053
% change from Historical	15.5%	34.2%	20.1%
Realistic Margin	£377	-£316	-£618
Margin/Assets	6.6%	-2.3%	-2.0%
Improvement in Asset Ratio	66.3%	54.4%	25.7%

Table 2 Impact of a Full and Fair Regime

For convenience, the percentage changes of each value from the historical summary are interpolated in Table 2 below each line of values.

The most dramatic impact is on the level of the realistic margin which moves from being strongly negative in the historic situation to being within a few percent of perfect balance under the modelled assumptions. To achieve this, average policy values at the end of 1989 are reduced by a third, which while quite fair is likely to arouse strong objections from the holders of older policies, notably those categorised as 'GARs', which have hitherto been favoured in various ways.

In contrast, premiums paid after 1994 would attract a value increase averaging about 15%, which, if it survived detailed scrutiny based on the fuller data available to your advisors, would be just about the first piece of good news the non-GARs have had for the last decade.

It must be emphasised that what we are attempting to calculate here is the proper return on the premiums contributed to an accumulating with-profits policy <u>based on the actual reported growth of the ELAS asset pool, year by year.</u> There is no averaging across the industry, nor any assumption of an idealised asset mix. The calculated entitlement is based on the returns shown with the annual Accounts.

The first issue that demands attention is this: *"Is it fair to allocate <u>gains</u> to older policies when most of the holders of such policies had no idea that they were being overbonused on a consistent basis?"* The answer is surely that it would not normally be fair to do so in order to recover the overpayments in question directly, which no one has yet had the temerity to suggest, but in the present case those who were over-allotted are imputed to be asking for a further subvention from the Public Purse as a compensation for perceived 'losses'. Personally I have no doubt that, <u>within a given policy,</u> gains and losses must be offset against each other, and only those showing a net loss can qualify for further consideration.

The next issue, which is closely related to the preceding one is: *"Where an investor held multiple policies, in series or overlapping, should the gains on some policies be set off against losses on the remainder?"* This arises in particularly acute form with holders of With Profits Annuities, many of whom previously held GAR policies which would show 'gains' under the Comparator system. They will point out that if they had opted for a fixed annuity, they would have kept their 'unearned' gains, but with a WPA, their undoubted losses would be substantially offset by such gains.

I interpret Mr Scawen of ELTA to be saying that such offsetting is fair and necessary, and I must agree with him, but only because <u>the losses for which WPAs are seeking redress were in large part caused by those earlier over-allotments.</u> In other words, the losses and gains are indistinguishable in origin, and this mandates that setting off be applied. Indeed, had all the WPAs opted for a fixed annuity instead, the negative impact on the Society's reserves would have been so large that it would have been technically insolvent in 1991 and again in 1994.[3] **This underpins the argument that all notional losses must be set off against related gains for the individual policyholder.**

There are also important but subsidiary issues of modelling 'mechanics', such as whether GAR business, WPA business and general pensions business should be treated as having separate bonus series, so that their premium pools should all have been ring-fenced from one another. I am sympathetic to the contractual arguments that this should always have been done, but I doubt that it makes very much difference in practice <u>once the realistic asset shortages are eliminated.</u>

It is clear in principle how a comparator system should be applied to individual policy histories: annual or monthly tables of allowed value accumulation as at the common 'Scheme Date' (taken to be '1 January 2010' for example) are first drawn up and applied to all the premiums contributed to each contract. Similarly all actual receipts of monies (net of MVAs etc) from the policy (including compensation payments) are revalued in the same way. A computer can easily interpolate when the termination date falls between two table datum points.

The question arises as to whether there would be a Compromise Scheme in the Sound and Prudent model, since it would not have been necessary in that financial situation. My conclusion is that necessary or not, it has to be assumed that the scheme was applied because it did change the nature of the GAR policies, but that the 'uplifts' it called for would have been based on the revised policy values computed by the model. The 'policy cuts' which occurred in the real world model would not have been applied in our alternative scenario.

If the time-adjusted modelled value is less than the total realised value, then no loss has been incurred, but if it is greater, then the <u>*quantum of notional loss*</u> is the difference between it and the realised value.

WPA and Managed Pension contracts (among others) present a complication because they involve periodic payments of pension which are treated as partial claims in the Accounts, and because they may continue for many years beyond the point in time when redress is actually made. In those cases, the Comparator model also shows us what the asset mark-up would need to be at the 'scheme date', and I would propose that the shortage in assets at that date be added to the net losses computed in respect of payments made before that date. [I have not

[3] This emerges from an exercise I have carried out for the purpose of reconstructing the total WPA position, year by year.

yet succeeded in persuading Mr Scawen that this produces results equivalent to his own more complex approach, but I am confident that this can be done.]

Deriving Redress from Notional Losses

Thus far in the discussion, I have emphasised the importance of "Sound and Prudent" management in connection with Policy Values and the allocations from the WP Fund. Similar considerations should apply to any scheme for calculating amounts of redress.

I have given much thought to this issue and would like to advance the following as the principles on which actual redress payments should be based. In doing so I speak for no one but myself, and I have a negligible financial interest in the outcome.

1. **<u>Transparency:</u> That the *Notional Losses*, calculated as proposed above, or in some other way that also allows for lost growth, should be the fairest practical estimate of what individual policyholders actually suffered from the improper management of their funds, and that these estimates should not be contaminated by any discounting for shared responsibilities or reductions for public policy reasons.**

2. **<u>Outrage and Hurt</u>: Policyholders paid their premiums in order to provide for a certain level of income through their retirement. Those who retired soon after the 2001 policy cuts suffered the most immediately, but those retiring (or surrendering) later suffered greater levels of cuts and greater anguish and uncertainty, much of this arising from the Government's policies of prevarication and procrastination. Moreover the recent immediate and full compensation of depositors in failed UK and Icelandic banks sets a contemporary precedent which is very hard to ignore. This implies that the calculation of redress <u>must seek to restore a substantial part of the *Notional Losses*, and to do so quickly.</u>**

3. **<u>Taking Responsibility:</u> While it is now clear that the Equitable disaster would not have been so extreme had there not been concomitant professional and ethical failures within the Life Assurance industry in addition to the regulatory failures which enabled the Society to go so far astray, it must be acknowledged that the Government and its agencies have done nothing to assist policyholders to make recoveries from third parties. The reverse is the case, as emerges so clearly from the Narrative of Events provided in the PO's Report. A relevant instance is the refusal to respond to the formal conclusions of the European Parliament including their demand for some effective scheme of compensation. Hence, it is now too late for the Treasury to discount full responsibility for the losses on the basis that other parties are also to blame. But, one of the conditions for redress should be that policyholders assign all rights to pursue third parties to the Treasury which should attempt such recoveries as are still possible.**

4. **<u>Ignore Extraneous Circumstances:</u> For a payments scheme to function swiftly and effectively, it must ignore extraneous circumstances such as the age, health and wealth of the recipients, so that payments can be made automatically without individual claiming or intrusive enquiries being required. Payments for 'past losses' should also be in tax-free form in order that the redress should not become yet another source of stress for those no longer able to deal with the complications of taxation rules. [Redress in the form of ongoing annuity payments could be subject to taxation in the normal way.]**

5. **<u>General Business Risk:</u> It can be argued that so far, no allowance has been made for general business risk which policyholders freely accepted and that the Scheme should not have the effect of indemnifying policyholders against such general risk. This might best be thought of as an element of 'self-insurance'. I can see no case for a deduction exceeding 20% of notional losses, and a 10% deduction would be altogether more reasonable. If such a deduction is made the net resulting figure should be referred to as the '*Allowable Loss'*.**

6. **<u>The Public Purse</u>: Whether or not it is justified, the reality is that the Treasury will be required to show that they have not been profligate with the Public Purse, and that they have trimmed the losses when calculating redress. I have set out some thoughts in Q&A form.**

- ***<u>Should small losses be further trimmed?</u>***
- **– Absolutely not; while for some the payments may be irrelevant, for others they may make a crucial difference to quality of life and settlement of debts.**
- ***<u>What is small in this context?</u>***
- **- A capital sum of £100,000 in a pension fund would buy only about two thirds of the current state pension for a single man. If redress is to be tax-free as proposed, then the equivalent figure is £80,000. So, there should be no further reduction on losses under £80,000.**
- ***<u>Should there be a cap on redress payment to an individual?</u>***
- **- If economies have to be made, this is one of the best ways of doing it, because it affects only a small proportion of those who have incurred losses, while still providing them with a substantial sum in absolute terms. A cap of £400,000 on redress would typically affect those with pension pots of over £1,000,000.**
- ***<u>Should redress be calculated on a regressive basis?</u>***
- **If there is to be an overall cap as suggested, then it could be argued that rather than paying 100% of net losses from £80,000 to £400,000[4], it would be more equitable, and more in line with the wider system of taxation, to divide the range into tranches and pay a smaller proportion of each tranche, (regressively). It is unfortunate for the policyholders affected that such an approach makes for a substantial reduction in the total cost of redress.**

[4] These figures "**£80,000 to £400,000**"are given purely as examples

7. <u>Ministerial Responsibility and Choice:</u> **It must be recognized that this whole matter has moved into the political arena where it is seen as a disaster where the Government has been landed with a large bill due to the negligent and irresponsible behaviour of one of its main regulatory departments. Nine years of legalistic procrastination which began even before the Society was forced to close to new business has merely aggravated the situation and increased the size of the bill. The devices suggested in your Terms of Reference for hiving off responsibilities will cut no ice at this late stage, and will surely harm the reputation of any Minister who tries to advance them as justification for restricting payments.**

   Surely the issue is not the number of juvenile excuses that can be advanced for not paying up, but the very real constraints on the public purse. Some senior member of the Cabinet has to stand up and say something along the lines of: ***"The bill for full compensation would be X which the country cannot afford…..and so it has been decided that Y will be made available to be distributed in accordance with the*** **'Chadwick Principles',** ***and this means (for example) that everyone must bear the first 10% of their losses and that larger losses will be treated less generously than smaller ones, and there will be a cap on the maximum payable to any one individual. The Government will also be seeking to recoup part of the costs via contributions from the Society's auditors and from the Life Assurance industry which would otherwise have borne substantial charges by way of its compensation scheme, but the success of these efforts will not affect payouts."***

To recapitulate, a Comparator based on Equitable Life itself, but applying Sound and Prudent management policies, provides by far the most secure ***and complete*** **basis for calculating losses on a 'per policyholder' basis. The case for recompensing the full allowed loss to everyone is strong, but real world considerations require us to examine mechanisms for reducing payments on the larger holdings. The approach also ensures, to the extent that data is available, that holders of older policies are not recompensed from public funds for 'losses' which are not real. It also avoids the genuine danger of endless and fact-based political debate over the validity of Comparator(s) assembled from the performance of competing life companies.**

Another advantage of this approach is that it most clearly maintains an understandable chain of causality between the "Decade of Regulatory Failure" and the calculation of allowable losses, in particular by setting the reference point of losses as the policy value that would have been achieved by sound and prudent management and not the profligate management which was actually the norm during the 1980s and thereafter.

Yours sincerely
Michael Josephs
