# EQUITABLE LIFE: PENROSE AND BEYOND
# - ANATOMY OF A FRAUD.

**A paper by Dr. Michael Nassim.**

**Contents.**


1) **Introduction.** p2
2) The Story before Penrose: a summary of some EARW main points. p4
3) **Level 1: Summary.** p8
4) **Conclusions.** p11
5) **Level 2: Narrative.** p12
    - Introduction: cipher, crib and key. p12
    - The Auld Equitable. p12
    - Out with the Auld and in with the New. p13
    - The New Equitable first turns sour- p14
    - –and then goes bad. p15
    - An illegitimate child: secret birth and prolonged unofficial existence of the DTBP. p17
    - From bad to worse. p20
    - Compromised. p21
    - Winners and Losers. p22
    - Rough news on smoothing generates new insights. p24
    - On Ponzi schemes in general, and the Society's in particular. p26
    - Prelude to regulatory considerations. p27
    - Regulatory failure I: Conduct of business. p30
    - Regulatory failure II: Prudential. p31
    - Fat cats and poor mice, or further inequities in conduct of business. p36
    - *Finale: cipher, crib, key and message.* p37
6) **Level 3: The evidential base.** p40
    - Scope and limitations of the PR. p40
    - Salient new facts and findings: p41
    - How, when and where did the Society's estate disappear? p41
    - So who gained the estate, plus further over-distribution at later policyholders' expense? p46
    - No estate + no un-hypothecated reserves = no smoothing policy… p49
    - …so how did the Society maintain the semblance of one under circumstances of chronic over-allocation exacerbated by debt? p49
    - Valuation and hypothecation considerations. p51
    - Policyholders' reasonable expectations (PRE), issues of good faith and related duties. p54
    - The Opposition view of regulatory failure. p57
    - Expansion and inflation. p58
    - Sophistry, mythology, propaganda, misrepresentation and mis-selling. p59
    - Corporate governance and management culture. p61
    - Loss and harm suffered by policyholders. p63
    - *Conclusion.* p64
7) Acknowledgements. p66
8) **References.** p67
9) Postscript. p68

**Introduction.**

In January 2004 the ELTA (Equitable Life Trapped Annuitants) website posted an account entitled: "An Equitable Assessment of Rights and Wrongs" (EARW) in advance of the Penrose Report (PR). It examined what had miscarried at the Equitable, the wrongs that resulted, and hence what a freely comprehensive investigation should cover. Therefore we may now add important new findings to this structure, and authoritatively indicate matters outstanding when assessing other reports. Even so the PR is long and detailed, and the opportunities to study it have been intermittent, during which there have been further developments. Hence the task has been arranged in stages. An initial appraisal appeared on the ELTA website in anticipation of the March House of Commons debate. A second interim evaluation dated April 20th was intended for committee members various, the Financial Ombudsman Service and the Society. A third version covering the non-regulatory aspects of the PR dated June 2nd was prepared for the ELTA committee. This fourth version includes some statutory and legal aspects, and takes into consideration the more relevant developments.

Though events at the Equitable remain the primary concern its regulatory dimension is also of great import; continued Government inaction here has resulted in this aspect being taken up by the Opposition and a vital handful of concerned MPs. Their initial success has been to consolidate the effects of the Equitable Members Action Group (EMAG) judicial review of Parliamentary Ombudsman Ann Abraham, and help persuade her to re-open her inquiry. For the sake of completeness this article includes an extract from a letter dated April 29th 2004 by Shadow Financial Secretary Andrew Tyrie to Ann Abraham, which lays out the evidence for sustained organisational and operational failures in the regulatory apparatus as recorded in the PR. This Mr Tyrie states to be the view of the official Opposition; with the source material and his references to hand readers may judge its merits for themselves. Alternatively, a listing of regulatory omissions and failures based on the evidence in this article, plus material assembled by the action groups in co-operation with the Parliamentary Ombudsman's Office in preparation for her Second Inquiry, is given in the narrative account below.

**How to use this article:**

First and foremost, the Equitable story is a long and complicated one. Its consequences have been grave, and can only be seen in reasoned perspective when everything has been set out clearly, and of necessity in sufficient detail. Mastering it entails hard work, which requires time and effort. To suit the differing amounts of either that readers may have, this paper is laid out on no less than four scales of detail and complexity, which are:

- Level 1: An itemised ("bullet point") summary of main points, and conclusion.
- Level 2: A fuller narrative account to provide overall continuity.
- Level 3: A categorised and itemised (numbered paragraph) detailed examination of important contributory issues, and-
- Level 4: embedded direct quotations from original sources.

Supporting this is a referenced fifth level, which comprises the source material itself. Some duplication of text or subject has proved inevitable in order to assist immediate comprehension and accessibility. And given the attendant responsibilities of the task, or that one must indicate where more facts or investigation may be required, even this sees barely enough. In presenting it the author must also acknowledge and contend with his own interests and limitations.

Because this paper is the accountable work of a single author, it should also be as self-sufficient possible. Hence again this is why, mainly at Levels 3 and 4 important new findings from the PR and other documents are quoted, summarised and referenced as numbered points under relevant headings. The writer has endeavoured always to place the quotations and summaries in a correct and impartial context. To indicate why they are important and to give continuity on a straight read through, other material, much of it also in EARW, is brought forward or referred to. This "mix and match" approach is much helped by there being no essential conflict between the PR and EARW, or indeed the several forensic and regulatory accounting papers by Colin Slater, a partner of Burgess Hodgson (Chartered Accountants)

who was until recently Chairman of EMAG, which can be found at **http://www.emag.org.uk**. Of particular note is "The alternative Penrose Report".

Readers may also have their own prior knowledge, but still there may be gaps. Having so to speak "grown up" with EARW, the writer thinks it remains a useful general approach to a complex problem, and so it may be helpful to go back to that. There is another good reason for doing so, namely that despite considerable overlap on aspects which Lord Penrose covers much more exhaustively and very well, there are other pre-defined areas which he has not been free to cover at all. Hence any gaps in the PR also need emphasis because readers need to know what these are, and wherever possible why they have occurred. But in the end nothing beats going back to the source material. The PR is downloadable by sections in .pdf format from **http://www.hm-treasury.gov.uk**. This is much faster on broadband, and upgrading ones reader to Adobe 6.0 permits searches of all the sections together if they are in one folder or CD-R. For other seminal material the EARW reference list and websites mentioned there will also help. It is also instructive to re-evaluate the Society's Compromise prospectus in the light of subsequent events.

In level 3 direct quotes are in "quotation marks", and passages of outstanding relevance are *italicised.* The writer has also underlined those areas of his own text to which he wishes to draw special attention. In the narrative text these markers could be a potential distraction from the main thread, and so are not provided.
At the risk of introducing an element of bias, the writer urges readers always to keep in mind the many aspects of differing or even conflicting interests as they digest his offerings. He believes that they have had a major bearing on events in areas such as:

- Fiduciary, ethical and professional competence versus personal ambitions and feudatory allegiances:
  - at the Equitable: influential London offices vis-à-vis the executive/administration arm at Aylesbury; executive vis-à-vis non-executive; actuarial vis-à-vis sales and marketing
  - in governmental and regulatory organisations
  - within professional bodies, e.g. actuarial and accountancy.
  - In the external relationships of individuals and organisations generally.
- Party political interests over the last 30 years or more
- Between members of Governments and civil servants, e.g. Treasury and regulators.
- Within and between a life office and its participatory pension schemes, administrators, actuaries and trustees.
- Between life offices: individually, or public versus mutual.
- Reconciliation of the interests of different categories of policyholders.
- Emasculation of official reports in deference to interests.

The two equal arms of the balance weighing these conflicts are objective clarity and the integrity of persons or their organisations. While the air is troubled the balance cannot settle, and the best we can do is to reckon the mid point of its swing at suitable moments, always looking to a steadying influence from those we may trust.

Regrettably, it is also necessary to recall the five cardinal elements of fraud, which are:

1. **"Scienter"** (Latin adverb/noun = "knowingly" in legal parlance), or knowledge of facts, events or circumstances by one party;
2. **Misrepresentations (including non-disclosure)** of that knowledge by that party in dealings with another;
3. **Reliance on those misrepresentations** by the second party;
4. **An agreement, contract, or transaction** between the parties which a reasonable person would not have entered into if privy to the first party's knowledge, and
5. **Harm or damage** to the second party as a result.

We should seek also to explain the motives for fraud, what is thereby gained and who might benefit. But as is increasingly known, the individual and collective mindset underlying modern corporate fraud can be complex. We cannot always expect the final satisfaction of uncovering a single old-fashioned "villain of the piece". The general issues underlying mis-selling and fraud by the Equitable are also covered in EARW sections 5, 7 & 8. But as we shall see, a few crucial new factors must now be added to what was discussed there.

**The story before Penrose: a resume of some EARW main points:**

*Sophisticated Plans and Practices*

Of central importance were seminal decisions and actions, which took place before Guaranteed Annuity Rate (GAR) policies were discontinued. They overturned the traditionally successful business and insurance paradigm of the With-Profits Fund, affected all policies sold subsequently, and adversely influenced the manner in which the Fund was administered and represented. Sophistries were the bedrock, and it is also relevant that they are in essence antithetical denials of the major lessons previously learned in the Society's own history. Of special importance was an overarching sophistry to the effect that a With-Profits Fund could be run on what has euphemistically been termed a negative technical solvency gap. This arises when the sum of all total policy values exceeds the assets, whereas absolute insolvency arises when the assets are exceeded by the sum of the guaranteed portions only in all policies. These two criteria can give rise to very different valuations and expectations of the asset shares of individual policyholders.

Though the un-guaranteed portions are unconsolidated, and might do multiple duties to cover other contingencies until required, ultimately they are a "moral charge" on the assets. In times when the unconsolidated terminal bonus element of policies is high this becomes important. The Society maintained that it was in practice unimportant, because its declared practice was to pay out total policy values (including the unconsolidated element) in full, such that this was policyholders' reasonable expectation. Effectively, therefore, the moral charge was thereby made a real one, and the difference was only unimportant so long as the technical solvency gap remained small or intermittent. But since this also implies a reserveless scheme, which could only work given well-nigh perfect forecasting, this was a vain and fallacious hope; of all people a succession of the Society's qualified actuaries should have known better.

The solvency gap arose because the Society's estate had disappeared, or was in process of doing so. How, why and when this occurred was held to be a matter of pivotal forensic importance, because the central sophistry sprang directly from it. In the Equitable's long history members and outsiders have repeatedly been tempted to raid the estate, and the Boards of Directors and the actuaries of the day had previously resisted this. It was therefore important to ask what other influences affected the Board and management on this final and fatal occasion, and if so why they were allowed. The resulting gap led to the transition from a With-Profits Fund for old and established members to a With-Liabilities Fund for newer and future members, which in turn could not have happened unless the fund also degenerated into a Ponzi pyramid selling scheme, fuelled by irresponsibly high bonus declarations and total policy values. In this it resembles the Lloyd's debacle, and the ensuing "recruit to dilute" campaign whereby asbestos claims liabilities were transferred from old to new "Names". Hence also the need to find out from what level in the Society any "incentivised ignorance" of sales personnel originated. This had be balanced against the more innocent picture of an office which was unduly influenced by commercial and marketing considerations and expanded too rapidly, giving away overmuch as incentives to gain new business and incurring excessive strain on any remaining reserves in the process. Marketing considerations could also have led the Society to ascribe overmuch importance to the profitability of investments in its sole asset mix when investment certainty and insurance should have been its overriding priority. Though there may be elements of truth in this, it did not explain the Society's persistently duplicitous and irresponsible conduct, or the origins of the faulted paradigm on which that conduct was based. Nor did it explain why the repeated warnings against injudicious expansion by eminent actuaries in the Society's own past were also neglected. Expansion demands caution because new business involves a heavy insurance element before much premium has accumulated, while the existing estate has to satisfy the expectations of yet more members unless it is increased *pro rata.* Moreover there is an inherent cost of chasing and winning the new business. The burden of all this is termed new business strain.

*More about sophistry*

First and foremost, the traditional estate is not a windfall inheritance to be squandered by the current generation(s), but is rather a charitable benefice held in trust, to be deployed for future generations as much as the present. But the Society had gone further, and moved into deficit by over-bonusing the existing members. So secondly, moving beyond disinheriting future generations and requiring them also to finance the "profligacy" of the current one only compounds this unfairness. Thirdly and as mentioned, the actual or potential running on a negative technical solvency gap is the very antithesis of prudent axioms of insurance, and flies in the face of experience, which argues for positive financial strength. Worse, it flouts the core concept of policyholders' reasonable expectations, and the consequent appellation of unconsolidated bonuses and benefits as a "moral charge".

When this business paradigm was presented as *With Profits Without Mystery (WPWM)*, a paper read to both the London Institute and Edinburgh Faculty of Actuaries in 1989 and 1990 members of the audience were unhappy with all this, essentially because it betokened a fund with scanty reserves, and perhaps insufficient financial strength in the event. They were also concerned that all policies were indiscriminately placed in the same unitised fund and asset mix, irrespective of their maturities or levels of guarantee, because under conditions of technical or absolute insolvency some policies would acquire inequitable claims on the remnants of the fund. Not surprisingly they wanted policyholders and their advisers to be informed of the potential risks that all this posed in accordance with the Financial Services Act of 1986. The published record shows that the expert discussants repeatedly emphasised the following:

- Adequacy and continuity of estate or reserves, to meet the needs of both present and future policies.
- The relative size of terminal and reversionary bonuses in policies, and the need to reserve for them.
- Potentially excessive mutual insurance arising from a pooled unitised fund in which the interests of policies of different lengths and levels of guarantee are indiscriminately placed.
- Given that the investment profile of a pooled unitised fund cannot be ideal for all policy types and durations, an additional mismatching reserve must be held.
- There is a consequent need to explain the potential inequity and risk this poses to policyholders and their advisers.
- Conversely, there is a need to explain the relevance of the guarantees, and how they will be met and charged for.
- Concerns about financial strength under all circumstances, given that the unconsolidated bonus element is used to take up new business strain while continuing to be paid out in full in the absence of an estate.
- The resulting duties of information.

The published words of the Appointed Actuary of the Society reveal that he paid overt lip service to duties of information to both policyholders and the Board of Directors, as indeed he had previously to reporting the "moral charge" incurred by the un-guaranteed terminal bonus element of policies in the official accounts. In practice, however, nothing effective was done in over a decade afterwards. And so all the important omissions, dissembling, concealments and deceits stemmed from the central sophistry, including dual and conflicting presentations of the new paradigm, firstly to a select but sceptical actuarial forum but then not the Society in full, and secondly of the accounts, an optimistic total policy asset share value version for members and a pessimistic discounted policy value asset share version for the regulator, which enabled the Society to survive for so long.

The coherence, consistency and duration of the ensuing misdemeanours indicated that when traced fully backwards they would have relatively few origins. As was explained in the main text of EARW, they are also tantamount to fraud because they satisfy the cardinal elements enumerated above. Hence it was concluded that there must be no residual doubt as to where in the Society's organisation (or even *via* external association) the important elements of deceit arose, when they did so, and in response to what circumstances. Human nature and corporate life being as they are, it was felt pointless to call for a witch-hunt until it was clear to

what extent the situation was a response to the pressure of evolving circumstances, or was more deliberately contrived. To understand all this required the recognition that there were persistently feudal aspects of organisational and institutional life. But if the Society's descent into fraud was insidiously cumulative, many officers and directors were thought either to have been too closely or loosely engaged to be aware of what the whole amounted to. Even so one could not escape the conclusion that some did know, or perhaps that others too long suppressed their real doubts. For the sake of the innocent this was held to need close attention.

*The Fall*

The underlying situation all this created was thus highly fertile ground for future trouble. After the initial market perturbations caused by the 1973 oil crisis there followed an inevitable period of brisk inflation and high interest rates such that equities also increased in monetary value and many pension funds began to acquire surpluses; at the same time traditional safe investments like fixed interest securities became less attractive. But when more normal conditions eventually returned interest rates fell and there was an eventual secondary reactive dip in the value of equities, which were no longer an indiscriminate hedge against inflation. Under these circumstances growing numbers of earlier policyholders (pre-1988) exercised their rights to guaranteed annuity rates (GAR) when they retired and took their annuities. The Equitable With-Profits Fund became technically insolvent, and to such an extent that the Society reneged on policyholders' reasonable expectations by cutting the terminal bonuses of those exercising the GAR option. As is now common knowledge, the House of Lords deemed this selection against one group of policyholders unlawful, and this decision precipitated the current crisis.

*Causes and Consequences of Regulatory Failure*

EARW explained why, in considering the conduct of government and regulators past and present, any rigorous analysis should cover three distinct periods, namely:

1. The role of the DTI/FSA* and governments of the day in the events leading up to the crisis precipitated by the GAR issue. (*Department of Trade & Industry; Financial Services Authority)
2. The handling, or lack of it, by the present government, Treasury, FSA and the judiciary in the run up to the Equitable Compromise Scheme arrangement.
3. Ditto in the events since the Compromise.

EARW also stated that, in practice, no regulatory apparatus can function any better than the milieu in which it operates. It provided evidence to the effect that, besides the Society, Government and the regulators had chosen to ignore the evidence for general mis-selling along the lines of the Lloyd's fiasco before, during and after the Compromise Scheme. Hence it was concluded that the informing and guiding influence of Government had also been deficient; had this been better exercised the consequences of regulatory failure would not have attained their present dimension. Instead the Government has chosen to be inactive and silent, which continues to gain it three advantages:

- A low profile and reduced need for uncomfortable decision-making
- Avoidance of responsibility
- Delay in settling for its share of financial consequences until as many Society members as possible have in different ways accepted less than their due.

But because some of the deficiencies occurred long before, during and after the Compromise Scheme vote, both political parties may have some responsibility for them. Readers were asked to remember that that the government of the day indemnified Lloyd's by special Act of Parliament before the Lloyd's Bubble burst. It was feared this might also inhibit the Opposition even though the Equitable Bubble is big enough to involve around 2% of the electorate directly, not to mention their dependants (Between 1957 and 1988 the Society had expanded to 170,000 members holding GAR rights; by contrast a further 930, 000 members without GAR rights were recruited over the next 12 years). (Happily, the Opposition have

since risen to the challenge.)  Meanwhile, governmental and regulatory inaction has had three enduring consequences for the Society and its members:

- It denied the New Board of Directors constructive external help at a crucial time.
- It allowed the Financial Services Authority to avoid reassuming its responsibilities, and advise on whether or not members should accept the Compromise Scheme.
- It has condemned the New Board to persist with and defend the discredited paradigm and all its consequences, to the detriment of members past and present.

Even so, the New Board should have known better than to maintain that mis-selling did not have a central and generic character such that future litigation could only be individual and piecemeal, or that the total shortfall in the funds was solely due to the GAR liability and could be as little as 1.5 billion pounds.

*Basic Wrongs Suffered by Policyholders (for full details see main EARW article):*

Most if not all have suffered the following:

- Loss of the security and benefits of a longstanding and traditional estate, most notably including loss of ongoing With-Profits Fund character and status.
- Excessive and inequitable mutual insurance, partly caused by unequal guarantees or the hidden penalties thereof; not yet fully resolved.
- Greater deficiencies in the Fund than revealed by the New Board.
- Harm arising from fraud, whether primarily intended or in response to circumstance.
- Harm resulting from regulatory deficiencies and government inaction, notably including:
- The necessity for the Society to persist with a discredited and deceitfully imposed paradigm.

The main EARW article also addresses factors affecting individual categories of policyholder. These largely depend upon their guarantee class, whether or not they accepted the Compromise Scheme, whether they are now annuitants and their status as voting members or otherwise, which in turn calls into question the role of their Trustees.

**Level 1: Summary.**

- The Equitable was founded in 1762, and until 1973 ran on established and prudent lines. Mainly based in London and the South East, it over the years earned an enviable reputation for the careful management of its inherited estate of reserves, which were passed down through successive generations of policyholders. From 1957-88 new policies contained a Guaranteed Annuity Rate (GAR) option at maturity.
- In 1969 pension regulations were changed, such that the Society stood to lose its institutional FSSU (Federated Superannuation Scheme for Universities) business. It began a compensatory sales drive. How it wooed new institutional customers remains unknown, but events were to show this was pivotal.
- As the Society grew its corporate governance and administrative base were modernised and extended. The central executive function at Aylesbury became progressively more important, and by the mid '80's 5 of the Society's 12 Directors were executives who included actuaries and marketeers. Unhappily these changes extended personal ambitions, and the executive became powerful, largely autonomous, and not properly answerable to the Board and members. It also stoutly defended the right to police its own activities. Ultimately this was disastrous.
- The sales drive was seriously affected by the 1973 oil crisis, which caused a market crash followed by prolonged and severe inflation which led into a sustained bull market. An unprecedented compensatory rise in interest rates followed. Over its course Appointed Actuary Barry Sherlock and his deputy Roy Ranson used the estate as well as appreciation and earnings to fund bonus allocations and boost the Society's competitive performance record.
- That year an un-guaranteed terminal bonus adjustment was introduced, and *as a matter of policy* it became the dominant bonus form. Fatally, the actuaries from then on repeatedly advised the Board that terminal bonus was cheap to service because it did not require statutory reserving. *Since this could only be true if the Society was prepared to renege on terminal bonus, it was a lethal seed of bad faith.*
- By 1983 virtually all the estate was consumed, and the remaining funds were taken up by unconsolidated terminal bonus. The with-profits fund was now a null fund. To support new solvency requirements under the 1982 Insurance Companies act, all remaining capital appreciation was brought onto the books. Sherlock was replaced by Ranson as Appointed Actuary, but remained General Manager until 1991. Meanwhile inflation was slowing and interest rates were falling, such that the GAR could be valuable. A "senior management team" privately formulated a differential terminal bonus policy (DTBP) to claw back terminal bonus retrospectively to fund the GAR. *The DTBP was in bad faith, and its non-disclosure was potentially if not then actually fraudulent.*
- In 1986 the Financial Services Act introduced more stringent disclosure requirements for financial products. And by 1987 at the latest the Society had allocated more bonus to support sales than there were funds to cover them. The entire estate and a sum in excess of all appreciation and earnings over the period 1973-87 had been distributed. In order to boost longer-term performance figures and to pre-empt historical difficulties over sharing out proceeds from the estate, most had been given selectively to longer serving GAR policyholders. And because of the GAR/DTBP position, the null fund had degenerated further into a "with-liabilities" fund. From now on it risked becoming dependent on future premium income and snowballing sales.
- The following year more flexible managed pensions were due, and the Society could discontinue its onerous GAR policies. The senior management team mixed the new policies with the old in the same fund, nominally in order to continue using the unrepeatably boosted performance figures. *From then on the Society traded on a false basis.* They did not advise the board that this produced inequities, nor did they reveal the DTBP. The DTBP and GAR, under circumstances of over-allocation and falling interest rates, established the with-profits fund as a with-liabilities one, and especially for the new non-GAR policyholders.
- *There was, however, by any reasonable standard an* ***absolute requirement*** *to disclose the DTBP and inequities of benefit and guarantee to non-executive members of the Board at this fateful point- and to minute the discussion. But equally, no competent non-executive director would have approved carrying over of the liabilities into an extended fund. Not only was this in continuing bad faith, but also the Society was finally embarked on a fraudulent course.*
- If the non-executive directors were not informed, then branch offices, sales representatives and members could not be and were not either. *Commission-earning sales staff operated in a state of "incentivised ignorance", and as they began to recruit new policyholders the fraud became*

*established.* By 2001, 930,000 new policyholders had been drawn to the lure of the Society's spurious performance figures.

- In fact the Society could not fully end GAR policies in 1988, because corporate and institutional scheme Trustees insisted on continuing them for a further five years. Effectively it blocked the DTBP for the same period, during which retiring GAR members could continue to crystallise their gains with impunity. This was a serious and hazardous inequity, which newer private members unknowingly funded.
- Other reasons why the relationship between the Society, its directors and officers, institutional and corporate clients and their advisers are an ongoing and material issue include:
    - The ability to exploit w-p fund and policy peculiarities with expert/inside knowledge.
    - Conflicts of interest: GAD had recommended the Society for Civil Service pensions.
    - Need for new scheme business and cordial relations with influential outsiders.
    - Favourable exit terms for scheme members prior to the Compromise.
    - No impact assessment of these matters by Lord Penrose and the regulators.
- In 1989 and '90 Ranson and his assistant Christopher Headdon delivered a paper entitled "With Profits Without Mystery" (WPWM). It was a *post hoc* rationalisation for disappearance of the estate and periodic over-allocation, and purported to justify using all the unconsolidated terminal bonus allocations to back the guaranteed portions of policies and finance the business in the absence of any free reserves. It necessarily exposed the Society to running on a negative technical solvency gap, despite which the authors maintained that the Society's custom was to pay the terminal bonus element in full as it fell due, such that it was of little importance whether bonus was guaranteed or not. *But since the Society was already over-allocated and falling interest rates meant that the covert DTBP terminal bonus claw-back would sooner or later become necessary, this exposition was part and parcel with pre-existing and fraudulent bad faith.*
- Unsurprisingly, the WPWM paper consisted of interdependent sophistries which are antithetical denials of all the Society's past lessons. Actuarial discussants picked most of them up, and notably commented on excessive, unsafe and inequitable mutual insurance in a pooled fund with no free reserves. They also said it was inequitable to mortgage the past against the future, and that unequal guarantees should be properly explained and charged for. These things, they publicly maintained, were duties of information under the 1986 Financial Services Act and actuarial guidelines. Ranson, now Appointed Actuary and an executive director since 1985, paid lip service to some of these observations, but neither he nor Headdon subsequently acted on them. *Prudence and Equity had now officially abandoned their oldest nest to cuckoo Fraud.*
- Despite whatever whispers there now were in actuarial circles, prudential regulators and the Government Actuary's department did not react. In 1987 Insurance Directorate Actuary George Newton had drawn particular attention to the need for prudential and conduct of business regulators to monitor the abilities of companies in Equitable-style predicaments to satisfy policyholders' reasonable expectations. The omission to follow it up was to say the least unfortunate.
- With all reserves gone and over-allocation now chronic, how else could performance figures be boosted? The answer lay in technical devices which eroded statutory reserves, and rising new business premium income from which to pay existing members (Inappropriate "gross premium" valuation methods diverted more premium flow for this purpose). The new liability thus entailed could be deferred, and allowances which anticipated continuance of premium income such as new business loans and a Zillmer adjustment were implemented from 1991 onwards.
- These actions effectively turned the "with undisclosed liabilities" fund into a Ponzi scheme which relied on future income. Because the latter was levered off the now dominant un-guaranteed part of policyholders' funds it was permissible by the letter if not the spirit of existing regulations, which were immediately enforceable only for guaranteed bonuses. And Zillmer adjustments were inappropriate because the majority of the Society's income was derived from recurrent single premium income business which could -and did- subsequently dry up.
- Interest rates were continuing to fall, and despite further extension of over-allocation the increasing GAR uptake rate was now a dangerous liability. The DTBP was deployed at the earliest practical moment, which was the end of 1993. It was later modified when it was realised that the value of the GAR might exceed all of a policyholder's terminal bonus. Reneging on guaranteed bonus to help plug the gap would *de facto* mean insolvency, and to avoid it the excess was made payable by ongoing members. This surfaced in Board resolutions of remarkable obscurity, and Ranson mentioned the DTBP informally *en passant* to

the prudential regulators. Events were to show that the non-executive directors, members and the regulators only slowly realised the significance of what had happened.

- Retiring GAR policyholders now encountered the retrospectively imposed DTBP, and as time went on they increased in anger and number. By 1998 the Society was obliged to fund the *Hyman* test case on the legality of the DTBP, which it explained to members in a measured and reassuring tone. The consequences of the DTBP increasingly preoccupied the Board, and some of the non-executives unsuccessfully attempted to probe the executives on the adequacy of solvency margins.
- Also in 1997 the worsening position was covered by a subordinated loan of indefinite duration at 8% per annum, i.e. junk bond rates. £350 million was thereby secured, but servicing it also depended on earnings such that only half of it counted towards regulatory solvency. And its dubious advantages were wiped out by Chancellor Brown's new tax on pension fund earnings, which Ranson estimated to worsen solvency by £500 million. Ranson now retired; Headdon and actuary Alan Nash respectively assumed his roles of Appointed Actuary and Managing Director in succession to Sherlock.
- Assuming the Society won *Hyman*, the DTBP could be imposed and the absolute insolvency margin of the GAR segment of the with-profits fund was between £15-50 million. But if the Society lost it was liable for up to £3 billion if all retiring GAR policyholders took their option, which declining interest rates had now made worthwhile. In the Society's precarious state this was impossible, and so attempts were made to re-insure the risk.
- The next moves were highly regrettable: full re-insurance was too expensive, and so Headdon entered into a show treaty which he privately lessened by means of a side-letter agreement. And as lately as Feb 2000 Nash informed policyholders that losing *Hyman* would cost no more than £50 million, i.e. what the Society would pay only if it won, and had been officially held on the books as such.
- In July 2000 the House of Lords ultimately found for Hyman against the Society, whereupon the situation unravelled rapidly. On Dec 8th 2000 Nash resigned as MD; Headdon resigned as MD and Appointed Actuary on March 1st 2001. Though the GAR uptake rate was now running at over 90%, the Society elected to value it using the overall historical uptake rate of 50% to arrive at a figure of £1.6 billion. Next the Society cut all policy values by 16% % overall, i.e. not merely terminal bonus. Since the contemporary value of the fund was around £32-3 billion, this represented a drop of £4.5-4.8 billion and was for good reasons a lot more than the cost of the GAR liability alone. This was discernible at the time, and raised uncomfortable suspicions.
- Suspicions were well-founded: besides the £1.6 billion GAR liability, £950 million of quasi Zillmer adjustment now had to come onto the books because both confidence and premiums dried up. The £350 million subordinated loan was also thereby exposed, and Chancellor Brown's £500 million loading was a further embarrassment. But over and above this, a normally functioning with-profits fund should have had free reserves of £3-5 billion. In truth the now hugely expanded fund was between £8-10 billion short of with-profits status, and over a million policyholders were involved.
- In response to this the New Board proposed a compromise whereby GAR policyholders had to surrender their GAR rights in return for having their policy increased by 18%, i.e. slightly more than before the July 2001 cuts. Non-GAR policyholders did not receive any material uplift in the Compromise. What remained was a null fund with no estate and no investment freedom, such that a defensive move into gilts and bonds was inevitable. And the discredited WPWM paradigm with its residual inequities of guarantee and continuing threat to any remaining terminal bonus remained in place. Corporate/institutional Trustees and their actuaries compounded these inequities by extracting their members for a mere 5% penalty. Inexplicably, the subordinated loan was not paid off, such that £750 million or so of the remaining fund is effectively earning no money.
- At this point the regulators had failed totally for 30 years. They misread the long inflationary wave and its distorting effects on competitive pressures. They allowed a w-p fund to disperse its estate inequitably, incur excessive new business strain and move into over-allocation, did not react to disquiet over the WPWM paradigm, did not probe ambiguities of hypothecation, allowed inappropriate gross premium valuation, and failed to react to the DTBP, subordinated loan and quasi-Zillmer adjustment.
- Despite energetic representations, the Society, Treasury, regulators and judiciary turned a deliberately blind eye to the surrounding irregularities, previous fraudulent non-disclosures, misrepresentation, mis-selling, and regulatory failure. In February 2002 the Compromise went through, such that further trouble became inevitable. Despite many further revelations and much protest their blindness, silence and denials have been obdurate.

**Conclusions.**

- Over the disturbed and inflationary period 1973-87 the Society consumed all its ancient traditional assets, and moved into over-allocation of bonus to current members so as to boost its performance figures in support of a sales drive to compensate for loss of FSSU business.
- In 1973 un-guaranteed terminal bonuses were introduced. Thereafter they were intentionally made the dominant bonus form. *Because they could be -and were- subsequently reneged, not reserving for them was in conscious bad faith.*
- In 1982/3, with a null fund, all free assets gone and the possibility of falling investment interest rates, a senior management team privately formulated a retrospective terminal bonus claw-back policy (DTBP) to fund previously given annuity rate (GAR) guarantees. *This too was done in deliberate bad faith.*
- By 1987 all the assets and more had been allocated to existing members, but new regulations provided an opportunity to end onerous GAR policies. *The senior management team elected to include new non-GAR members in what was now a with-liabilities fund and continue using the unrepeatable boosted performance figures, thereafter trading on an entirely false basis.*
- At this stage there was by any reasonable standard an **absolute requirement** to disclose the risks to which both existing and new members would be exposed, given the resulting inequities, over-allocation and existence of the DTBP. *And since no competent non-executive director would have approved this situation, the non-disclosure is understandable but necessarily fraudulent. Institutional & corporate business & interests are a contingent issue.*
- If the full Board was not informed, then nor could be anyone else. Hence, *once ignorant commission-earning sales staff commenced selling the new policies, the fraud became established, finally trapping over 1 million people.*
- In 1989/90 the Society's actuaries delivered and published a manifesto paper, which was a series of interdependent sophistries purporting to justify running a so-called with-profits fund containing diverse policies without free asset backing and resorting to periodic over-allocation. The paper proclaimed that because the Society's practice was to pay out policy values in full, it did not much matter whether bonuses were guaranteed or not. *Given over-allocation plus the undeclared DTBP, the entire exposition was also in fraudulent bad faith.* The actuarial audience was understandably sceptical.
- Over the period 1987-2001 over-allocation was extended by devices that eroded statutory solvency margins, subordinated debt and inappropriate adjustments which anticipated future premium income, such that the fund degenerated further into a Ponzi scheme.
- The DTBP emerged in 1993, but was not rightly and finally declared illegal until 2000. The hugely expanded £32 billion fund unravelled, indicating a deficit of £8-10 billion. The deficit comprised a nominal 1.6 billion GAR liability, 1.3 billion of loans and adjustments, 0.5 billion extra assets to cover Gordon Brown's new tax, necessary free reserves of £3-5 billion, and the remaining over-allocation gap which became exacerbated by recent stock market falls.
- Both prudential and conduct of business regulators failed to react to any of the many warning signs of this progression despite their special knowledge and responsibilities. Their failure was in part systemic, but predominantly operational and hence attitudinal. Regulators engaged in sometimes self-absolving debate about the inches while the ship was off course by miles and headed for the rocks.
- Some of the regulators, and most notably the FSA, remain locked in denial in continuance of self-absolution. The FSA deliberately ignored the evidence for fraudulent mis-selling before the Compromise, since claiming to have investigated and rejected the case without revealing its grounds. It denies operational and attitudinal failure, and its current Chairman does not acknowledge the need for a second Parliamentary Ombudsman Inquiry.
- Despite continuing denial, overwhelming contrary evidence has shifted the burden of proof to the FSA and the Society. They must now demonstrate that the with-profits Fund did not lose its status on disappearance of its free assets; that it was not thereafter trading on a false basis by using unrepeatably boosted performance figures, that it did not then become a with-liabilities fund under circumstances of chronic over-allocation complicated by the GAR/DTBP issue, and that at no time did it degenerate further into a modified Ponzi scheme implemented by an ignorant sales force. *If so, then no fraud.*
- As anticipated, although he filled many crucial gaps Lord Penrose stopped short of the whole story or according blame. The current situation demands an Eliot Spitzer.
- If the Society became the antithesis of its former self, so has the FSA, which is now a public danger. It is no ordinary loose cannon because it fires on its own side as it rolls unaccountably around the decks. It stands urgently in need of reform, and of being made properly subject to Parliament and the Nation.

**Level 2: Narrative.**

*Introduction: cipher, crib and key.*

The Penrose Report is over 800 pages long. Though its twenty chapters have highly relevant headings there is no index. Lord Penrose is scrupulous both in his careful reporting of important facts, and of the context in which they arose. But having carefully prepared his ground he has usually stopped short of making deductions or inferences from it, and on contentious issues he often quotes the reasonable opinion of others rather than giving his own. All this makes the Penrose Report (PR) somewhat like a cipher. Without a crib and some prior knowledge it is very hard to find the key and crack it. A halfway decent crib also tells the decoder what new information is of special importance, whether there is anything missing in the message, and if so where else to look. Just as well, then, that a crib was prepared on evidential and logical grounds before the PR appeared, because the additional knowledge in the decoded message turns out to be vitally important, if in places also intentionally or of necessity incomplete.

The main crib is a preparatory article entitled: “An Equitable Assessment of Rights and Wrongs” (EARW). To establish its independent authority, and to pre-empt allegations of hindsight, it was published in advance of the PR. Its findings and conclusions have been brought forward elsewhere in this paper because it aimed to explain what was already known, and hence what a comprehensive inquiry should cover. It also provides an analytical and interpretative framework within which to place new evidence. By using it in this way the following story has emerged.

*The Auld Equitable.*

Founded in 1762 as The Society for Equitable Assurances of Lives and Survivorships, the Equitable attained by degrees an unrivalled reputation for ethically prudent and fair management. This was primarily due to the influence of the Reverend Dr Richard Price FRS and his nephew William Morgan FRS, who in over 50 years of loyal service as Actuary raised it to unparalleled heights of eminence and prosperity. Part of the Society’s early prosperity was fortuitous, and rested on persistently conservative mortality figures and relatively high premiums based on mortality tables from the city of Northampton. More intentionally it relied upon Price’s insistence in 1775 that moneys be retained as “…a reserved stock, not to be entered upon save in seasons of particular mortality…the interest…to be added to the principal, till it shall rise to such a sum as may be deemed a sufficient surety in all events”. This was the origin of the Society’s estate, and the source of its secure reputation. How big the estate should be became a recurrent bone of contention in the late 18$^{th}$ and much of the 19$^{th}$ century; the Court of Directors had repeatedly to resist or moderate demands for a distribution of surplus to existing members. If they were not to receive all the Society’s funds, existing members also had an interest in limiting new members’ access to them, and so they lobbied for restrictive conditions or delayed bonus entitlements for the newcomers. Had these conflicts of interests not been resolved the Society might have died out, and indeed there was a prolonged period of stagnation before cautious and controlled expansion began later in the century, continuing in the first half of the 20$^{th}$.

Originally the Society gained interest on fixed interest securities, and after reserving for its liabilities distributed the surplus proceeds. Fairly soon it diversified into bonds and mortgages, and as the investment milieu developed it also began to invest in property and equities. It distrusted the inherent volatility of capital appreciations in property and equities, and brought this officially onto the books only in small amounts. As befitted its London origins most early members were Londoners, and throughout its history the London branch offices remained confined to the City, West End, Law Courts and Westminster. It thus had close associations with the Establishment and City financiers, many of who were its clients, and from whom it drew its directors. Even at the height of its expansion there was a preponderance of offices around London and in the South East. Its head office was in London, but many of the support administrative and executive functions (including the actuarial and marketing departments)

were later centralised in Aylesbury. On the increasing centrality and autonomy of the executive team there much was later to depend.

The Society's organisation long reflected its social origins. There was in consequence a clear distinction between the Directors and the executives, very few of whom became members of the Board. Maurice Ogborn, who wrote a most informative history of the Society to celebrate its bicentenary in 1962 and was the last of the Society's actuaries to champion the estate principle, was the first actuary to be appointed to the Board. In the 1970's and 80's this changed. Executive representation on the Board rose to 5 of 12 members, and there was less of the old master-steward/servant relationship. This was properly so, and in the course of it the more able and ambitious executives might gain wider career horizons and more influential business contacts. Events were to show that this blessing was a mixed one.

Those interested in the Society's history prior to 1962 should in the first instance consult Maurice Ogborn's bicentenary history entitled: "Equitable Assurances".

*Out with the Auld and in with the New.*

Things might have continued without a marked change in direction had it not been that a large amount of the Society's pension scheme and institutional/corporate business came from the Federated Superannuation Scheme for Universities (FSSU). When insurance regulations were changed in 1969 the Society recognised that a newly competitive climate would emerge, and that it stood to lose a substantial amount of this business. To mitigate it new branch offices were opened and the sales force enlarged in preparation for a concerted expansion drive. While preparations were in hand for this, in 1972 Maurice Ogborn retired. This proved to be a bad omen, because 1973 was disastrous for the Society in no less than five ways. Firstly, the Society had embarked on a five year expansion plan, to which it was now committed. Secondly, this was immediately compromised by the international oil crisis with the collapse in confidence and of the markets that attended it. Thirdly, Ogborn's successor Barry Sherlock and deputy actuary Roy Ranson elected to maintain a high level of bonus payouts that the Society could ill afford to avert collapse of the marketing drive. Fourthly, they introduced an un-guaranteed terminal bonus adjustment which was originally intended to bring policy values more into line with investment earnings on a triennial basis. Fifthly and fatally, the Board of Directors was informed that terminal bonus was a relatively cheap benefit to service because it did not need to be reserved for with any stringency; a message that was to be repeated frequently over the years.

This reassurance was technically correct but in practice false, and dangerously so if too heavily relied on. Implicit was the supposition that if the going became too hard the terminal bonus could be revoked. This was an original and perilous seed of bad faith, which in time became a veritable tree, whose roots eventually exhausted and undermined the fertile inheritance in which it grew. The initial phase of exhaustion was rapid, and brought about by maintaining bonuses in support of the sales drive. Much of the Society's estate was dispensed in the 1973-6 triennium as both declared and terminal bonus, and the more so because the estate's investments were at a temporarily depressed value. Solvency margins were maintained by bringing longer-term historical capital appreciation onto the books, and by increasing the valuation rate of interest required to support the liabilities- a device used again in subsequent years.

The crisis in market confidence was relatively short lived, and recovery began in 1974-5. This merged imperceptibly with a prolonged period of inflation, which was at least partly due to a three to fourfold rise in the oil price. Given the dominance of oil, and that in the modern economy energy is vital for the preparation of all goods and the implementation of most aims, stability could not return until wages and prices had risen by a corresponding amount. Under these circumstances the first phase of the secondary inflation wave was unusually severe and prolonged. This initially restored and then increased the monetary value of the Society's equity portfolio. It also dealt a deathblow to the traditional belief that fixed interest securities were the surest haven for savings, because their real value was eroded correspondingly.

On these shifting sands a desultory attempt was made to rebuild the Society's fortunes, but it was doomed to failure. Much of the Society's capital appreciation of its investments was now inflationary, and hence an illusion. But taken at face value it seemingly justified holding bonus rates at high levels to maintain market competitiveness. It also encouraged a progressively greater percentage of capital appreciation to be brought forward onto the books, and the rise in volatility that this engendered was in part offset by increasing the relative proportion of un-guaranteed terminal bonus, which over subsequent years grew to become the major bonus element. All this had particular significance for the 1977-9 triennium, and Lord Penrose nicely explains how the three-call earnings allocation system was manipulated to increase the proportion of un-guaranteed terminal bonus at the expense of declared bonus, and all in the name of policyholders' expectations. Whatever, it had the desired effect of retaining a gratifyingly large number of former FSSU policyholders, and increasing sales. President Murison contentedly announced that this left the Society well poised for the next decade, but in retrospect the exact opposite was the case, and with hindsight was clearly in bad faith. While brisk inflation continued all looked rosy, and since at the same time there was a compensatory rise in interest rates, the existing contractual rights of policyholders to opt for a Guaranteed Annuity Rate (GAR) at maturity appeared well covered. Indeed, the GAR was increased to maintain competitiveness while interest rates were high, and this later had dire consequences.

*The New Equitable first turns sour-*

As the inflationary 1970's drew to a close the Society's premium income had begun to increase exponentially, which rise continued until the collapse of 1999-2000. Part of it must also have been due to inflation, although the sales drive was also increasingly successful such that there were 170,000 members with GAR policies before an attempt to end them was made in 1988. But now another problem was approaching, in the shape of more stringent financial and reporting standards to be imposed by the 1982 Insurance Companies Act. In the event the changes of 1982-3 were also to prove as momentous as those of 1973. They included the following:

a. All capital appreciation, whether past or current year's, was now put on the books to support solvency.
b. Barry Sherlock stood down, and his deputy Roy Ranson became the Appointed Actuary. However, Sherlock remained the Society's General Manager and Actuary until June 30th 1991.
c. The crude level of terminal bonus, before any smoothing, was now related more or less directly to the investment reserve (see also e. below). The Society's long history of a separate estate was effectively at an end.
d. Hence Ranson was later able to say that he did not inherit an estate on becoming Appointed Actuary. Even so, Sherlock and he had been party to the disposal of that estate over the period 1972-83.
e. The absence of an estate, with terminal bonus now taking up virtually the whole of the remaining unconsolidated investments, may have been instrumental in a decision by the Aylesbury senior management team to put in place a fall-back differential terminal bonus policy (DTBP), in case falling interest rates later came to put GAR option holders "in the money". This fallback DTBP was not communicated to the Board of Directors.

Arguably this concealment of the DTBP by the management team (some of whom were also executive directors), in the particular context of the underlying fund structure and financial weaknesses which made it necessary, was the fateful first step in a subsequent descent into fraud. What is beyond doubt, however, is that it was the first branch on the growing seedling of bad faith. Consistently with this, 1982/3 was also when the sophistries later elaborated in the notorious "With Profits Without Mystery" (WPWM) paper and business manifesto began.

The extra margin of regulatory solvency the1982/3 manoeuvres produced was now also distributed. The Society proceeded to erode the apparent strength of the 1982 balance sheet by progressively cutting back on the reserve for future (guaranteed) reversionary bonus until it was eliminated, they had used up a previously un-attributed accounting adjustment from

1982, and finally had explicitly, at least in 1987, made a bonus allocation in excess of available returns. This situation continued for most of the Society's remaining life. It was therefore necessary to tread a narrow path very carefully, which was facilitated by keeping accounts reflecting no less than three approaches to asset and liability valuation, namely Companies Act accounts, Department of Trade and Industry (DTI) regulatory returns, and internally for management purposes, an "office" valuation. Of these the private office valuation most closely approximated to the Society's actual financial position. This too was fundamentally bad faith.

The year 1987 was fateful in other ways, because it heralded a change in pension regulations which permitted cessation of the old Retirement Annuity Plans containing the increasingly onerous GAR option, and the introduction of more flexible personal pensions. Crucially however, the game had again been raised by more stringent requirements for the accurate disclosure of the essential nature of financial products by the Financial Services Act of 1986. Given the Society's underlying financial situation and that interest rates were falling to the point when the GAR option would bite, this was part welcome opportunity but part serious challenge if sales were to be maintained. The response of the senior management team was to go beyond ingenuity.

*-and then goes bad.*

Lord Penrose prefaced his description of the team's 1987response with the following extract from the Actuary's report: "A strategy document was formulated by the end of March and agreed by the senior management team. A major component of the strategy was to make use of existing products, as much as possible, in order to minimise the changes needed to existing administrative and computer systems, and to enable the Society to exhibit an unbroken track record of past performance". He prefaced the extract with the following: "The paper did not identify features of existing business that would be departed from". –and continued: "The new form of business was to be presented as aligned with the superseded retirement annuity contract to ensure that previous performance records could be used with reference to the new contract. In management records it was noted that premium bases would be the same as for retirement annuity basis. In the present context the decision was reflected in distribution practice going forward.

In relation to bonus policy, this was a momentous, and ultimately disastrous, decision. Had the Society acknowledged liability to meet the annuity guarantees, it would necessarily have identified a difference in the benefits provided by the former and the new contract forms. For equal premiums, the new personal pensions offered lower levels of contractual benefits. On conventional actuarial practice the Board might have concluded that a higher level of bonus was appropriate for the new business accordingly (or, as was later observed during the actuarial discussion of the WPWM paper, explaining the significance of the guarantees and charging for them appropriately- MN). The means of calculating the difference were available in the developing techniques of stochastic modelling. The Society might have avoided the *Hyman* problem at the outset.

There would undoubtedly have been marketing implications. Policyholders might have preferred to switch to the new forms, the marketing push of 1987 and 1988 could have been abortive. The Board might have been forced to propose a new with-profits fund, closing the old fund to new business. But adopting a market-driven policy, against the background of the management decision in 1982-3 to "solve" any emerging problem by discriminating at maturity (i.e. the DTBP- MN), established the bonus policies and practices that were thereafter to develop, and to lead to the confrontation of 1997".

Lord Penrose omitted to make two most important conclusions about the consequences of this position. Firstly, because the record of past performance had been achieved by disposal of the estate to a fortunate minority and all was now gone, there was no prospect of repeating it. From this point onwards the Society was trading on an inherently false prospectus. Secondly, he did not add that, however uncomfortable it may have been, there was by any reasonable standard an **absolute requirement** for the executive directors on the senior

management team to disclose the existence of the covert DTBP to the full Board at this fateful stage, and indeed to minute the ensuing debate. But had they done so, it may safely be asserted that any reasonably competent non-executive director would not, could not or should not have contemplated the risk that, together with loss of the estate and persistent over-allocation, thereby transferred to the new fund and its future policyholders. What was carried over was the very antithesis of a with-profits fund. From this point on, if not since 1982-3, the Society was trading on an entirely false basis. The seedling of bad faith was now a sapling of fraud.

Over the next twelve years the sapling would become a specimen tree in every sense. The magnitude and duration of the resulting fraud is truly astonishing. Eventually the tree's new branches would ensnare a further 930,000 unsuspecting new non-GAR members, and the older branches supporting the GAR policyholders would be cut from under them. The burden of responsibility carried by the "senior management team" is correspondingly heavy. We may with reason wonder who the instrumental members of that team were over the period 1982-8, and look forward to the Serious Fraud Office bestirring itself to tell us. Not surprisingly, a number of non-executive directors since 1987 have pleaded their ignorance; under these somewhat undefined circumstances it hardly seems fair that, whatever their personal shortcomings, their fate should be left entirely to the whim of the adversarial process.

The events of 1982-7 thus overturned the traditionally successful business and insurance paradigm of the With-Profits Fund, affected all policies sold subsequently, and in time adversely influenced the manner in which the Fund was administered and represented. That representation developed into a set of interdependent sophistries, which it is also relevant to observe are in essence antithetical denials of the major lessons previously learned in the Society's own history. Of special importance was an overarching sophistry to the effect that, in the absence of an estate, a With-Profits Fund could be run on what has euphemistically been termed a negative technical solvency gap. This arises when the sum of all total policy values exceeds the assets, whereas absolute insolvency arises when the assets are exceeded by the sum of the guaranteed portions only in all policies. These two criteria can give rise to very different valuations and expectations of the asset shares of individual policyholders.

Though the un-guaranteed portions are unconsolidated, and might do multiple duties to cover other contingencies until required (of which more elsewhere), ultimately they are a "moral charge" on the assets. In times when the unconsolidated terminal bonus element of policies is high this becomes important. The Society maintained that it was in practice unimportant, because its declared practice was to pay out total policy values (including the unconsolidated element) in full, such that this was policyholders' reasonable expectation. Effectively, therefore, the moral charge was thereby made a real one, and the difference was only unimportant so long as the technical solvency gap remained small or intermittent. But since this also implies a reserveless scheme, which could only work given well-nigh perfect forecasting, it was a vain and fallacious hope. When formally delivered and published as a paper entitled: "With Profits Without Mystery"(WPWM) to the London Institute of Actuaries in 1989 by Roy Ranson and the Edinburgh Faculty of Actuaries the following year by his deputy and co-author Christopher Headdon, expert members of the actuarial audience were unhappy with all this, essentially because it betokened a fund with scanty reserves, and perhaps insufficient financial strength in the event. Actuaries were also concerned that all policies were indiscriminately placed in the same unitised fund and asset mix, irrespective of their maturities or levels of guarantee, because under conditions of technical or absolute insolvency some policies would acquire inequitable claims on the remnants of the fund. Not surprisingly they wanted policyholders and their advisers to be informed of the potential risks that all this posed in accordance with the Financial Services Act of 1986. To this Ranson in his responsible capacity of Appointed Actuary paid overt lip service, but in practice nothing effective was done in over a decade afterwards. And so all the important omissions, dissembling, concealments and deceits stem from this sophistry, including dual and conflicting presentations of the new paradigm, firstly to a select but sceptical actuarial forum but then not the Society in full, and secondly of the accounts, an optimistic total policy asset share value version for members and a pessimistic discounted policy value asset share version for the regulator, which overall position was privately monitored by a more realistic internal office valuation, and which enabled the Society to survive for so long.

WPWM has rightly been the focus of much subsequent interest. Important though the details are (they are rehearsed and referenced elsewhere in this paper because they are not well covered by the PR), it is here more relevant to concentrate on four critical background factors. Firstly, the underlying prospectus based on the Society's past performance was as we have seen false. Secondly, undeclared DTBP meant that the relative amounts of guaranteed and un-guaranteed bonus could be crucial, in contrast to what WPWM stated. Thirdly, the Society was by this time over-allocated, and its financial position was already weak. Fourthly, interest rates had fallen to the point where the GAR option had become valuable, such that there was a real possibility that the Society's covert contingency plan to revoke un-guaranteed bonus would be used. And fifthly, despite what was written and published in the main paper, Ranson had during the 1990 Edinburgh discussion intimated that if things got difficult the un-guaranteed terminal bonus element would be the first thing to go. Taken together, these factors indicate that the WPWM sophistries were motivated by more than bad faith, and that they were an integral part of what was by then a fraudulent position.

The unvarnished truths behind the WPWM gloss would hardly have been more acceptable to the Society's WP policyholders and members than previously to actuaries, particularly since as members they were also its owners. Judging by the extracts given in the PR, Barry Sherlock as senior actuary and general manager did not adequately disclose the whole situation and its attendant hazards to policyholders in his 1989 report. But though he was an executive director, he had since 1982 been more concerned with the overall direction of the Society from the London end, and it remains unclear how familiar he was with the background events of 1982-7. We may nevertheless reasonably assume that he had read and sanctioned, if not actively edited and approved, the 1989 WPWM paper. And he it was who had given away the Society's estate in order to supercharge the Society's performance record, which gained it approbation, influential support, and an increasing amount of new business which was both private and institutional.

*An illegitimate child: secret birth and prolonged unofficial existence of the DTBP.*

In Chapter 2.51-104 of his report, Lord Penrose examines the origins of the differential terminal bonus policy. He differs from the earlier Corley report as to the date of its origins, largely on account of Headdon's written and oral evidence from the autumn of 1998 onwards, which included depositions to the Treasury Select Committee and his own Inquiry. In 2.61 he writes: "At a meeting of executives of the Society arranged to discuss the annuity guarantee issue in the autumn of 1998, Headdon gave a presentation on the background. He gave further information about the origins of the practice. He stated:

"that internally the current argument (i.e. linking of guarantees) has been the consistent view for the last 15 years."

Fifteen years would have taken the discussion back to 1983 soon after the fall in interest rates in the autumn of 1982. The guaranteed annuity was briefly in the money at that time. Headdon's account has been consistent since, and is accepted as reliable evidence. It is consistent with the manuscript notes referred to (see P1.33): specific provision for a situation that could not be dealt with by a differential final bonus scheme would be more likely to reflect a belief that the more usual contingency had been dealt with than it had been overlooked. I consider that it has been established that at a differential guaranteed annuity terminal bonus policy was conceived at the latest in 1983, and in a context in which discussion would have been appropriate. It would follow that it was understood when the change to personal pensions took place. The evidence supports the view that the Society's actuaries were conscious of the implications of a long-term fall in interest rates from 1982, or, at latest, early 1983, and that there would be implications for bonus, both reversionary and terminal. The precise form that the differentiation would take in case of need was not defined at that time, so far as the evidence has disclosed."

In P2.110-113 Lord Penrose concludes:
"On the evidence available to the inquiry, the differential terminal bonus policy was the established policy of management from about 1982 or 83. The inquiry has uncovered no evidence to indicate that the policy was widely advertised to staff until about 1998. Similarly,

apart from the general comment in *With Profits Without Mystery*, there has been no evidence that the board were informed of the policy before December 1993. The policy was first implemented in 1993-4.

It also seems clear that the critical decision not to split the with-profits fund at the point that personal pensions were introduced was taken (whether explicitly or not) on the basis that the Society intended to market the new policies as a simple development of the existing policies, relying on the investment record and returns to policyholders of the existing fund, and minimising the administrative burden for the Society. Management at least had recognised the potential value of the annuity guarantees within the existing policies, and are likely to have relied, implicitly, on the differential terminal bonus policy in making that recommendation. But there is no record that the inquiry has found to suggest that this was an explicit consideration so far as the Board was concerned.

It would be consistent with the inquiry's general findings on corporate governance that in the contexts of valuation of liabilities, product design, and the computation of policy benefits, executive management exercised a wide discretion unconstrained by active board supervision. It is this that enables the inquiry to conclude that the differential final bonus policy was developed in 1982-3, and influenced matters such as the treatment of personal pensions after 1 July 1988, the amendment of group and AVC contract forms, leaving retirement annuity contracts unaltered, the application of level premium bases to apparently incompatible classes of business, for example, without the Board of the Society being actively involved in the development of the policy and its implications for business generally. It appears unlikely that most members of the board knew of the differential terminal bonus policy or its implications until the autumn of 1998, or that those who knew anything of the policy understood that it could have serious implications for the Society."

Given the Society's precarious position, deployment of the DTBP would have had less serious public consequences had it been possible earlier than 1993. Its deployment would, however, have led to a collapse in the Society's sales drive, and with it the chance of more widely diluting – even of concealing - its liabilities. However, the circumstances related in "Fat cats and poor mice etc." below made it impolitic if not impossible to deploy the DTBP before the end of 1993, by which time the inequities and liabilities of the new fund had been considerably increased.

So much for the date of deployment; now to the manner of it, which could hardly have been a proud affair. Such formal record of the DTBP's announcement as was made to the board is related in P2.80:

"On 22 December 1993 the board passed a resolution in these terms:

"The Board approved the changes set out in the statements attached to the paper"

The paper on which the board had proceeded had proposed a range of changes in bonus rates in the light of experience to date, and stated:

"The attached amendment to the formal statement of bonus agreed at the 10 February 1993 Special Board makes that change…"

Among the detailed material was a new paragraph to be included in the notes to retirement annuity bonus notices relating to differential bonus policy: paragraph 7. The narrative of the report made no reference to this, and there was nothing in the record to suggest that particular attention was drawn to it. The note stated:

"Where benefits are taken in annuity form and the contract guarantees minimum rates for annuity purchase, the amount of final bonus payable is reduced by the amount, if any, necessary such that the annuity secured by applying the appropriate guaranteed annuity rate to the cash value of the benefits, after that reduction, is equal to the annuity secured by applying the equivalent annuity rate in force at the time of the benefits are taken to the cash value of the benefits before such reduction"

As related in P2.96, this statement was repeated in February 1994, but on this occasion prefaced by a related note dealing with the cancelling out of the benefit of guaranteed interest rates (GIRs) and other additions in certain circumstances. It reappeared in subsequent years, and stated:

"Where the contract terms guarantee any increase in benefits by way of interest or other addition for the period from 31 December 1993, or such later date of purchase of benefit as applies, to the date of payment of benefits, the amount of final bonus allotted… is reduced by the amount of any such increase." This passage is worth the diversion, because with hindsight we can see that it is material to continuing debate about residual inequities in the with-profits fund, and the disparities in bonus rates for GIR and non-GIR policies which became evident for the first time in the 1996 bonus declaration. This has been covered previously in section 10 of EARW, to which those interested may again refer.

At some point after 1993 the actuaries must have become aware that, if the disparity between the guaranteed annuity rate in possession and current annuity rates at maturity was sufficiently large, the commensurate reduction in accrued terminal bonus would exceed the amount available. As previously explained (EARW Second Order Sophistry Item 5), any further reductions in policy value would come from the guaranteed fraction, which *de facto* would have indicated insolvency. Hence when this point was reached it could not be indicated, and a sum in excess of the policyholder's discounted asset share had to be paid out, which could only come from the with-profits fund's other pooled assets. And so in the 1998 declaration the now standard GAR/DTBP text had an amended ending: "…value of the benefits before that reduction, subject to a minimum value for the final bonus after such reduction of zero (P2.102)"

The GAR/DTBP was modified again shortly after this, because the first complaints to the PIA Ombudsman had been intimated in July 1998, and the Board had taken legal advice from the Society's solicitors. The new text read:

"The non-guaranteed final bonus is the sum which the Society would need to allocate to the policy by way of addition to the guaranteed value to produce the total value of the benefits available if taken in fund form and used to purchase an annuity on current rates. The actual amount of any final bonus will be the sum which the Society would need to add to the guaranteed value at retirement in the financial conditions prevailing at that time in order to produce the then actual total value. If the policyholder takes benefits in guaranteed annuity form, and if guaranteed annuity rates are higher than current annuity rates, the amount which would be needed to be added by way of non-guaranteed final bonus in order to bring the value of the benefits of the policy up to the stated total value will be less than that required if current rates were applied, and could be nil (P2.103)."

It is hard enough for the average person to divine the meaning and significance of these passages with hindsight, let alone a director in the context and at the time they surfaced. As yet there are no minutes and no uncontested evidence that the actuaries ever made verbal reference to them before 1998 or thereabouts, or that any non-executive director questioned their import. However, in P2.81-2 Lord Penrose relates that Peter Martin had publicly stated that the "solution" devised by the actuaries was presented to the board in December 1993, and approved. He also told the Inquiry that non-executive director Alan Tritton had queried it in 1994, and received Roy Ranson's affirmation that the DTBP was "OK on Contract" (having been assured that the Board had article 65 *vires*). Tritton has no recollection of this exchange. Another account of these differences has been given by Mr Justice Langley in paragraphs 49-58 of his October Strike Out Judgement. Though we may duly note it all, we should not speculate further at present. But it is abundantly and consistently clear that from its inception in 1982/3 the DTBP was never given the prominence that it deserved by those who devised and implemented it, until external events both forced and allowed them to do so. And by 1993 the new with-profits fund structure and status was an established *fait accompli,* such that the pivotal damage had already been done. Again, therefore, let us pose the uncomfortable question as to why these important matters were not minuted in 1993/4, let alone 1987/8, or indeed what their relationship may have been to the conduct of the Society's institutional and corporate business in the light of insistence on retaining GAR rights for a further five years.

The DTBP was not formally disclosed to the regulators, but mentioned *en passant* by Ranson at a meeting on November 30th 1993. The circumstances are related in P16.114-123, from which it is here sufficient to quote the following:

"116. In the course of discussions about the resilience test, Ranson remarked that the Society's pensions business had a guaranteed annuity rate at about 7%, and said:

> "…but this was not as onerous as it appeared since, because old policies had been given the benefit of more modern features and options, it would be reasonable (in his [Ranson's] view for the allocation of final bonus to be conditional on waiving this guarantee".

Handwritten jottings by the line supervisor on the face of some of the board papers provided[19] suggest that Ranson confirmed that the guarantees were not reserved for, and that Rathbone* may have queried whether this was consistent with PRE.

117. In this way, the existence of the annuity guarantees and Ranson's proposed solution were apparently disclosed to both GAD and DTI at this meeting. However it was not followed up and did not receive another mention in the regulatory papers until after the issue had been exposed in 1998…"

[19] "Guarantees-don't reserve for them", "We have no guarantees that <u>bite</u>. JR: PRE?".
* GAD Principal Actuary John Rathbone.

If the regulators had hardly been vigilant or even diligent, the manner of this disclosure is consistent with everything else noted above. With this hurdle cleared by fair means or foul, the Society could claim *carte blanche* to implement the WPWM paradigm fully. How that paradigm might have been represented to the board can in part be judged from an investment considerations report presented by Ranson on March 28th 1990 (P4.38-50). 1990 had been a difficult year, and the paper reveals much about contemporary policy and freedoms it allowed. Here it suffices to note the following quotation from it in P4.47:

> "9. The most technically and financially efficient way of allotting the return for the year would be to apply it wholly by way of an increase in the "unconsolidated" or "final bonus" element of policy values. This element is not guaranteed, requires no capital to finance it and is only paid out on policies leaving the fund. Hence it is very well suited to the situation where future earnings are being anticipated. If it eventually emerges that we have "got it wrong", the damage is limited and room for future manoeuvre is retained".

With the DTBP finally out of the closet over 3 years later, the position could be, and was, fully implemented. It neatly condenses and encapsulates many of the issues covered in this paper.

*From bad to worse.*

Loss of the estate and the events of 1982–7 had effectively transformed the "with-profits" fund firstly into a "null" fund, and then into a "with-liabilities" fund owing to continued over-bonusing and the covert DTBP. Yet even though the Society was now over-allocated, the marketing pressure to stay at the top of the payout league intensified. Moreover the Society now needed yet more members to help service its hidden deficits. If inflation and interest rates had stayed high, and markets continued to register large gains, deficit-linked underperformance might have been obscured. The taking on of too much underwriting risk attendant upon new business before much premium had been received (i.e. "new business strain") would similarly have been eroded. But this was not to be, and the Society's position became progressively more exposed.

In the event the position was covered in at least three additional ways. They were:

- A modified or quasi-Zillmer adjustment which assumed continuing future premium income, against which some of the liability could be set.

- A subordinated loan of indefinite duration serviceable at the rate of 8% p.a., which if the Society were to be wound up would in theory not be met until the liabilities to policyholders had been discharged.
- A treaty whereby some of the Society's liabilities were conditionally re-insured.

In fact, although a Zillmer adjustment had been mentioned in the 1989 WPWM paper, it was not utilised until 1990-91. Eventually, however, £900 million pounds of liability was covered by it. Among other options to maintain solvency a subordinated loan was first mooted in 1993, and eventually a £350 million pound loan at 8% interest was launched in 1997. Like the quasi-Zillmer adjustment, servicing it depended upon future earnings, such that only about half the value of such a loan could be counted as an asset for solvency purposes.

1997 was a turning point in other ways, because any good effect the new business loan might have had was more than cancelled by the withdrawal of pension fund earning and tax credits by Chancellor Gordon Brown in the same year, which according to Roy Ranson was equivalent to wiping a further £500 million off the Society's statutory reserves and solvency margin. Given the other pressures on solvency and how they had been dealt with, this is likely to have been a relatively optimistic estimate. 1997/8 was also when GAR policyholders' challenge to the DTBP became public news with the onset of the *Hyman* case. Assuming the Society won, the ultimate GAR liability with the DTBP fully implemented was estimated at different times to be between £15-50 million, which the writer has previously conjectured in EARW to reflect the absolute insolvency margin of the GAR segment of the with-profits fund. But if the Society lost, the cost of the liability would be very much higher. Just how high depended on the percentage of GAR policyholders who took up the option when their policies matured or were contractually surrendered. A middling estimate was 50%, which could publicly be justified as reflecting the historical average GAR uptake. With this prospect looming Roy Ranson retired. It ultimately led to an estimated GAR liability cost of £1.6 billion in Society's annual report for the year 2000.

The tide of the *Hyman* case ebbed and flowed, and ultimately the House of Lords ruled against the Society. There was an urgent need to restore confidence. It was thus both irresponsible and inaccurate for Alan Nash to maintain as late as February 2000 that the liability was of no consequence to the Society, because it would be no more than £50 million. The Society may have thought this was justified because, as previously explained in EARW the official contingency figure for the liability had been held on its books at £50 million. The reality was thus incompetently or consciously deceitful. And it transpired that the reinsurance treaty was negated by a side-letter agreement signed by Christopher Headdon in April 1999 that had not been declared to the regulators. In effect the treaty had been for show only.

*Compromised.*

Given the complex realities of the underlying situation, the House of Lords decision could not have ended all controversy whichever way it went, or whatever form of words it might have taken. Yet much of that controversy is informed by hindsight, whereas their Lordships' judgement may be viewed as just and reasonable within the contemporary face value context of its likely financial implications as intimated by the Society. The measured and responsible tone in which the Society represented the *Hyman* test case and its progress to its members and policyholders suggested little cause for alarm. But as we have seen, the underlying reality was starkly different. Not only was the Society over-allocated, but as the premium stream dried up any relief afforded by the quasi-Zillmer and subordinated loan disappeared. And since the Society could no longer renege selectively on GAR policyholders' terminal bonus by means of the DTBP, that liability had now also to come onto the books. The Society opted to value it at 1.6 billion pounds, and cancelled any bonus additions for the last 7 months of 2001, nominally in order in order to cover it. But even as they did so, GAR uptake rates were running at 90%, which the 2000 annual report showed would cost twice as much.

However, despite all the previous public reassurances, under the WPWM paradigm it was possible to remove terminal bonus entirely, although now it had to be done even-handedly. There was thus plenty of slack in hand for maintaining statutory solvency. And so the next move was to reduce all total policy values by 16%. Almost unbelievably it also entailed *pro rata* cuts to members' guaranteed funds, and this the regulators allowed. Since the total fund value then stood at over £30 billion, the cuts represented a drop of some £4.8 billion, which

agrees well enough with the PR's £4.5 billion shortfall estimate. That would cover 3 billion of GAR, 1.25 billion of quasi-Zillmer and subordinated loan, and Chancellor Brown's £500 million or so. Now the GAR policyholders could in part be bought off with seven months of retained earnings and cancelled bonuses in exchange for their GAR rights, in which case their total policy values would be marginally more than restored by an 18% uplift. The non-GAR's had to accept a nominal 2% uplift, which in the event did not materialise. In effect, therefore, GAR fund values were held as ransom for surrender of the GAR right, and the non-GAR's had to cover the statutory solvency gap which now threatened. The Society's fundamental inequity was thereby more equitably restored, and all were the worse for it. From then on with-profits status was lost, and all w-p members equally must cover solvency without the backing of any free reserve. Meanwhile either all (GAR) or the residue (non-GAR) of policyholders' terminal bonuses is thereby placed in jeopardy.

As related elsewhere, private members and ex-members received no external help or guidance in making their decisions to vote for or against the Compromise. And despite increasingly urgent representations about the irregularities underlying more general mis-selling and misrepresentation the Treasury and regulators turned a blind eye to them. The record also shows that these included two direct allegations of fraud by retired trust solicitor Nicolas Bellord and ex-banker Arthur White at the S425 legal hearings, but that they were dismissed by Mr. Justice Lloyd or not minuted. Mr White has since taken his case to the European Union. Corporate and institutional trustees and their consulting actuaries went in to bat for their members, in which case they could extricate them on favourable terms; history has not yet officially related whether any of the New Board of Directors were in any way their nominees.

Four awkwardnesses remained. The Compromise could not restore any kind of free assets or estate, and the Society's recent history had shown that investment freedom, smoothing and any reasonable return net of overheads could not all be funded from a fluctuating deficit. With-profits fund status was thereby forfeit, and a defensive investment strategy had to be adopted; a move into bonds followed (see also Cazalet Consulting's evaluation of the contemporary situation). This was just as well, because the long bull market subsequently turned and despite some recovery has remained relatively depressed. A rectification procedure for imposing the DTBP on GAR policyholders whose policies had matured between 1993 and 2001 had also to be implemented, but progress has been slow. And lastly, annuities in payment had to be cut to reflect fallen policy values. As related previously in EARW, the Society bided its time until the inconveniently timed government FSAVC review and compensations had been decided before making these cuts in Nov. 2002. Effectively, therefore, the Society complied with FSAVC (Free Standing Additional Voluntary Contribution) annuity and fund value uplifts after the Compromise that it had no intention of honouring. A final awkwardness, namely residual inequity of guarantees which had come into existence under the aegis of the WPWM paradigm, was simply ignored. As also explained in EARW it notably includes convenient ambiguities and discretions in the implementation of Guaranteed Interest Rate (GIR) policies.

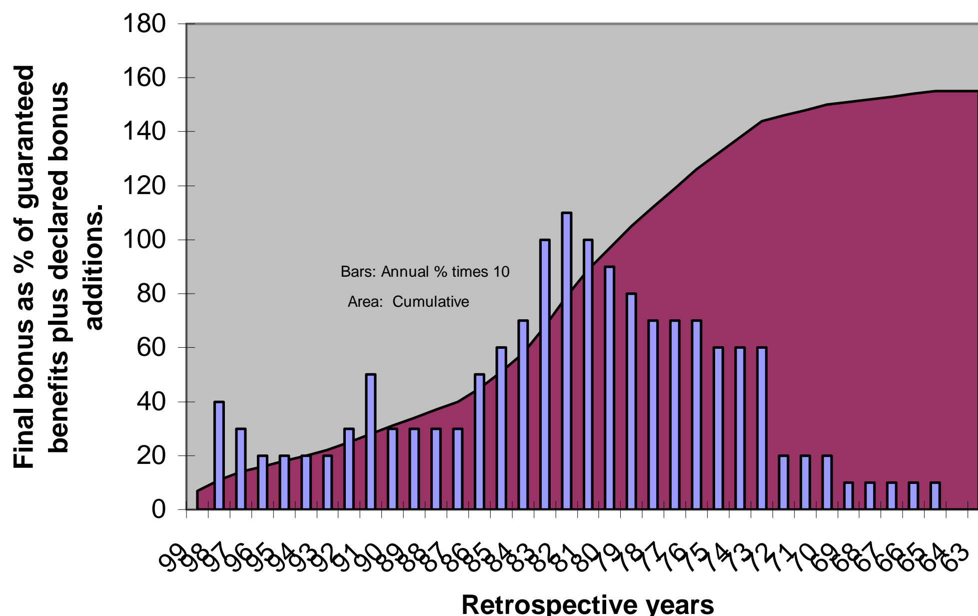
*Winners and losers.*

Besides saying how the money may have disappeared, Lord Penrose has also indicated where and when it did so. Professor Smith's presidential statement in the 1992 accounts includes: "… The fundamental philosophy is that each generation of policies should receive benefits commensurate with the earnings produced during its lifetime. Beyond the bounds of normal commercial prudence, it would be alien to our culture to hold back benefits from one generation to build reserves for a future generation. As we say in our literature, for new policyholders future bonuses must depend primarily upon the earnings produced on the investments of the new premiums. Any deliberate cross subsidies between generations would not be "equitable". Lord Penrose comments: "As appears frequently in these documents, there was an inherent contradiction in the statement. If nothing was held back for the future, any over-allocation had to be recovered from the future. That had to involve deliberate anticipatory cross-generational subsidy and to be, in these terms, 'inequitable'" (P4.82-3; see also EARW p7). Did Professor Smith know this?

A more detailed account of cross-generational subsidy is given in P6.71-3. Lord Penrose explains: "…While the split between GIR, reversionary bonus and final bonus might vary depending on the policy structure, the same total return was credited to accumulated policy values regardless of duration. This contrasted with the practices of many other companies with significant amounts of single premium business, where more flexible bonus systems allowed for variation according to duration in-force and financial experience over the relative periods. This flexibility allowed inter-generational smoothing and enabled the company to avoid locking in to payout patterns in the way the Society did" (¶ 71). And: "More generally, it is unclear on what basis the Society could ever have expected to have been able to operate without inter-generational transfers in the absence of flexibility to differentiate by duration. In With Profits Without Mystery it was acknowledged that each generation of maturing policies was dependent on capital provided by succeeding generations (cf. Ponzi in narrative below-MN). Flexibility to differentiate by duration would have been necessary for such a system to operate fairly in the absence of an inherited estate. The Society's practice did not provide that flexibility, and, given its full distribution policy, over-payment on older duration policies was the direct result" *(*¶ 73). This, then, was a crucial piece of knowledge for better-informed policyholders or groups if they wished fully to exploit product flexibility, and the availability of total policy values from 1987 onwards. It also seems fair to assume that few individual members without access to well-connected financial advice would have known of it.

With this explanation in mind it is also instructive to look at PR Table 6.13 and 6.16, which show how terminal bonus became increasingly dominant over the years 1980-2000. The story can be made more complete and the effects of it judged by graphing a Society promotional table showing terminal bonus accumulation over the 35 years preceding 1999 expressed as a percentage of all the guaranteed elements. It forms part of Society leaflet (45J099 WP/UL 2.99) entitled: "Pension and Life Assurance Plans. Annual Statements-Further Information". When plotted as in the figure below, the data show that the biggest relative annual terminal bonus additions were made over the 1973-86 period, i.e. that spanning the dispersal of the estate during which Barry Sherlock was the Appointed Actuary and subsequently Managing Director. This was also the period of steepest relative accumulation rate of terminal bonus. The graphs also indicate how much terminal bonus was awarded retrospectively to policies in force during the decade prior to its introduction in 1973.

**Growth of final bonus working backwards from the 1999 policy anniversary.**




NB: The cumulation profile illustrated is **relative** to the guaranteed elements of individual

asset share and guaranteed bonus cumulation (the cumulation of which is also important for determining the **absolute** amount of asset share, which in turn depends upon individual contribution history). It assumes a constant level of annual contribution, but, given the structure of the fund, suitably informed policyholders might have done well to increase their later contributions. They would also then have had to crystallise their gains at an appropriate and advantageous time; later policyholders whose policies had more time to run were perforce left exposed, and had also to meet the costs of previous over-distributions (cf. Ponzi below). After 1985/6 the real glory days of terminal bonus and potentially crystallisable gain were over. From the sales point of view it all looked very impressive, and so it is not surprising that the senior management team wished to carry these figures over to support a new fund in 1987. The prospect of such performance continuing on the same basis was, however, entirely without foundation, such that the use of these prior performance figures was inappropriate, un-representative, and misleading.

The beneficiaries of "deliberate anticipatory cross-generational subsidy", who received the rump of the estate and more between 1973 and 1987, were thus longer duration policyholders who were in other ways also selectively favoured (P chap 3.46, 51, 60, 74, 94, 103, 109, 112, 129, 144, 145 items 5 & 8, 152, 161 & 168; chap 4.16 &36; 14.68). And since the GAR option was withdrawn for policies begun after 1988, this group was also essentially comprised of longer-term GAR policyholders. Moreover after 1987, "The advertisement of "policy value" to members who had reached an age at which it was open to them to take their benefits allowed those with the financial acumen or appropriate advice to elect for an early maturity date and crystallise their benefit entitlement at an unduly high value to the disadvantage of continuing members. In the early 1990's, this was facilitated by new flexible products developed by the Society" (P chap 4.29). The implications of this are serious, and the more so if they involved fund switching. One reason for the selective bonus allocation to policies of particular durations was said to be maintenance of the Society's position in performance tables, i.e. marketing considerations. And yet, as initially explained, the historical problem was that established members would resist significant increases in membership because it diluted their own claims on the estate. Given the Society's commitment to expansion, it would have been politic to forestall this by awarding longer-term members a disproportionate share of the estate. One must also hope that similar favours were neither sought nor proffered for inward transfers of longer duration policies during the drive for expansion.

Depending upon personal and external circumstances, postponement of retirement could also achieve the same end. Consider, for example, Headdon's explanation of why the actual results for 1995 had shown payments to policyholders considerably in excess of those projected for the year. " It appears that some clients were delaying retirement until the managed pension contract became available. A substantial part of retirement proceeds will, in fact, have been left with the Society and contributed to the premium income position…". In the same paragraph (chap 4.128) Lord Penrose continues: "The consequences of the managed pension for policyholders was to become a significant factor in the closing years of the reference period. Evidence from the independent financial adviser sector indicates that some at least some of its practitioners appreciated that it was to the advantage of their clients to take benefits at a time when policy values were high relative to underlying assets."

*Rough news on smoothing generates new insights.*

If an investment fund holds free reserves in one form or another, they confer the ability to even out fluctuations in earnings from year to year. The greater the reserve, the longer returns and bonuses can be maintained at what is deemed to be a safe average level in times of adversity. If there is no estate or other free reserve, then earnings cannot be smoothed out in this way. Not surprisingly, therefore, Lord Penrose was unable to establish that the Society had a defined smoothing policy despite its officers having repeatedly referred to the existence of one. It is, however, possible to discern what substituted for one from the WPWM paper, parts of Sherlock's 1989 letter to policyholders, and a revealing exchange recorded in the PR between Christopher Headdon and Ernst & Young audit actuary Ian Bannon in 1995. Under the WPWM paradigm there was no estate or free reserve; in the absence of one the unconsolidated surplus, i.e. all the accumulated terminal bonus, became what was referred to as the "investment reserve". One of the grey areas in the 1989 WPWM paper was exactly

what the investment reserve would be called upon to do until it went to policyholders. In concise technical terms it was unclear how such surplus was hypothecated before it "crystallised" on becoming contractually due in maturing claims.

First and foremost, in the absence of any other funds the investment reserve had now to be the surety for the guaranteed element in policies. Effectively, therefore, policyholders' un-guaranteed bonus was used to underwrite the guaranteed part of their own fund value, and with hindsight one may well question what sort of a guarantee that was. The investment reserve had also to finance ongoing with-profits and other business, and to take up new business strain as the Society's membership grew in advance of anticipated premium income. A *bona fide* custom of paying out full policy values in a climate of good faith required the investment reserve also to stand as guarantor for itself. This in turn inevitably meant that in market conditions when underlying asset values were depressed, and all the previously awarded terminal bonus stood at more than market value after also having to cover any associated shortfalls in guaranteed bonus, the investment reserve would be negative. Under these circumstances, the only way individual total policy values could be maintained was to allow supposedly limited swings of the investment reserve between positive and negative. And since this could only work under uninterrupted relative stability in market conditions, any capital smoothing capacity was more apparent than real. Moreover once the Society had compounded this situation by attempting to extend it with loans and re-insurance treaties the position was ultimately untenable. Come the GAR liability payable in good faith and the situation was hopeless without the bad faith DTBP claw-back.

Whatever the deficiencies in this situation, it purported to maintain total policy values rather than to dampen pulsations in the yearly bonus stream. Supposedly it smoothed capital value rather than any annual additions to it, which notwithstanding Sherlock's limited explanation of it is not a layperson's ordinary understanding of smoothing. Moreover, rather than risk thereby reducing it extended indefinitely, and increased progressively as premiums and dominant terminal bonuses accumulated. Meanwhile, if a steady stream of annual bonus additions were to be maintained at a level that satisfied market expectations, these were a deferred liability that did not require immediate further setting off against the investment reserve, and allowances for future premium income such as Zillmer adjustments, subordinated loans or bonds and internal business loans, all of which anticipated the income continuing could be swung in to cover them. But in fact most of the Society's policies were recurrent single premium ones, such that a steady annual premium flow could not be taken for granted. Even so, the PR demonstrates that an inappropriate quasi-Zillmer adjustment was ultimately extended to cover £900million of the Society's shortfall in funds. When the premium stream began to dwindle in 1998/9 the position became progressively more uncovered.

With these inherent weaknesses there remained but one means of sustaining the notion of smoothing, and paying out total policy values in full as they matured or were surrendered on contractual terms in a manner that did not further erode statutory solvency margins. As revealed in the Headdon-Bannon exchange, it was to pay the unconsolidated terminal bonus part of claims as they arose from a first call on the Society's current earnings, always against the aforementioned backdrop of positive-negative swings in the value of the investment reserve. By contrast the guaranteed part of maturing claims was struck out from the guaranteed liability reserve.

This overview of smoothing or the lack of it is worth following because it allows several further significant insights. Firstly one can recognize that different accounting standards may contain disparate conventions for hypothecating free assets, let alone a so-called "investment reserve" of assets which are not free because they are being held against an eventual liability. Hence disparities or elective shifts in hypothecation of any resulting deficit, obscured by the Society's sophistry-laden business paradigm, are what allowed key members of the senior management team successively to elude most of the Society's directors, virtually all its members, the organisation of the Faculty & Institute of Actuaries, the Society's auditors and the regulator. Herein lay the usefulness of the three different sets of accounts. More sinister is the realisation that "first call" payouts from current earnings, and a bonus stream predicated on future earnings rather than inherent financial strength, are characteristics of accumulating new business strain followed by a Ponzi scheme. In this as in so much else, the many aspects of non-disclosure are paramount, but on the face of it the Ponzi scheme was legal,

because it was all levered off the un-guaranteed part of policy values. Even so, the London and Edinburgh discussions of the WPWM paper show that an informed and interested minority of the actuarial profession could and did deduce much of what was going on. As yet, history has not related what other representations they made within their profession, or how else they may have used their knowledgeable inferences.

*Of Ponzi schemes in general, and the Society's in particular.*

Pyramid selling scams are also known eponymously as Ponzi Schemes. In the 1920's Carlo "Charles" Ponzi elicited subscriptions to buy postal credits cheaply abroad, and cash them in more expensively in the USA. Though the idea sounded attractive it was unworkable, but Ponzi maintained the illusion of success by paying earlier contributors "interest" from the growing stream of proceeds from newcomers. So long as the income stream comfortably exceeded payouts it was worth continuing, but when questions began to be asked confidence was eroded, whereafter the stream at first hesitated and then dried up. At this point Ponzi defaulted, and 40,000 people lost their subscriptions. From this one sees that:

- Because it is unworkable, the central rationale is not what it purports to be.
- If the rationale is unworkable, any prospectus based on it either false or unsound.
- Since the perpetrator knows the prospectus is false, or has good reason to suspect that it may prove to be unsound, there is an implicit but secret point of default, and the scheme is in bad faith.
- An unworkable rationale cannot create genuine wealth for monetary returns.
- Even so, success is mimicked by paying past contributors with the income from present and future ones.
- The illusion of success is thus a confidence trick.
- Apparent success plays on the confidence of yet others to contribute, and so on.
- So long as subscription income and any interest it earns stay ahead of payouts, the scheme is worth maintaining. Meanwhile everything hangs on confidence.
- When confidence collapses, and payouts threaten to overtake income, the scheme defaults.
- Besides the perpetrator(s), a minority of earlier contributors can end up better off.
- Beyond paying for the gains of others, latecomers also incur the running costs of a barren scheme and lose their money.

In the context of the Equitable it is now apparent that:

- After the loss of the estate and yet further over-bonusing plus the GAR liability, the so-called "with profits" fund was a "with liabilities" fund, and no longer what it purported to be.
- Since the traditional "with profits" fund no longer existed, any rationale based on it had to be traduced, and was thereafter either false or unsound.
- Instrumental members of the executive function knew that the resulting prospectus was false, or had good reason to suspect that their assumptions might prove to be unsound.
- Since they knew that the WPWM business paradigm was false, or had good reason to suspect that it might not hold, they had privately put in place a default, whereby the terminal bonus element of GAR policies could be revoked in proportion to the size of the GAR advantage. From this point on the "with profits" business manifesto was uttered in bad faith.
- As eventually brought out by the vagaries of the market, there was no longer an estate or free reserve with which properly to finance an investment policy that permitted safely genuine monetary returns as befitted "with-profits" fund status.
- Even so, the illusion of success was initially maintained by awarding existing members at least a portion of the estate, and once it had all been dispensed by over-bonusing them to create a liability that needed financing by present or future members.
- Though the impression of success was illusory, it led to consistent triple A ratings from the financial press. The reality was more of a confidence trick.
- Apparent success was material to the entrapment of 930,000 further policyholders.
- Since all now depended on confidence, in the absence of sufficient genuine returns over-bonusing had to be maintained and credit extended in order to maintain it.

- The interest rate climate changed, GAR policyholders were "in the money", and despite sharing out the liability more widely over new members it became necessary to revoke their terminal bonus. The DTBP emerged from its 10-year secret existence, and the Society defaulted on its declaredly *bona fide* position.
- This was challenged by GAR policyholders, and eventually the *Hyman* case of 1997 led to the default being declared illegal by the House of Lords decision in 2000. In response to this confidence first seriously faltered in 1999, and then evaporated in 2000.
- With the loss of confidence, the premium stream dwindled and all but died over 1998-2001. Since the premium stream was being used to cover some £1.3 billion of over-allocation, this sum had now to come onto the books, and be added to the existing deficit and cost of the GAR option, whatever they were.
- At this point, the Society's 1.25 million or so policyholders had to share the full deficit among themselves. Older GAR policyholders, who had previously benefited from the 1973-87 giveaways and over-bonusing roughly in proportion to the duration of their membership, were not so badly off. Those policyholders who had crystallized their claims prior to the market value adjustment in July 2001 and subsequent Compromise retained all their previous gains, but they were by no means all the170, 000 GAR policyholders. The reward for non-GAR policyholders and latecomers was thus in many cases entirely liability, and no profit.

All this came more or less within the letter, if not the spirit, of contemporary legislation. This is because "ponzification" was confined to the unconsolidated and un-guaranteed fraction of policy values. And as we have seen, this modified Ponzi scheme also provided the illusion of smoothing. One way or another, under the now discredited WPWM paradigm Society could renege on the whole of the un-guaranteed fraction, so long as it continued to pay the guaranteed fraction in full. What was and remains at stake is thus substantially more than the GAR liability, because the WPWM fund structure is still largely in place. Here it is again worth recalling the extraordinary impropriety of the officially sanctioned 16% cuts to total policy values in July 2001, which reduced guaranteed portions *pro rata*.

*Prelude to Regulatory Considerations:*
*Policyholders' reasonable expectations, issues of good faith and related duties.*

First note that, in discussion following C.S.S. Lyon's paper *The Financial Management of a With-Profit Long Term Fund- Some Questions of Disclosure* in 1988 (EARW section 5, p11), Roy Ranson had said: "I support the author's suggestion that the, to use his words, "moral charge" which existing terminal bonus has on the free assets might be reported. If the free assets remaining after such an exercise were used as a sign of so-called "strength", such a disclosure would need to be supplemented by a note about the office's approach to with-profits business". But by this time the Equitable was over-allocated, such that Roy Ranson as its Appointed Actuary had no basis for making this important statement, which under the circumstances could only obscure and mislead. The simultaneously emergent reality, which would have been both revealed and supported by the Society's triple accounting process, was very different. The triple accounts were, moreover, deployed in a manner antithetical to Ranson's 1988 statement, such that we can only conclude that this was done in deliberate bad faith. Lord Penrose observes: "However, the accelerating growth in terminal bonus payments was fairly consistent over time. And that pattern emerged whatever the current financial experience of the Society (it should have implied the existence of an effective smoothing policy if all was otherwise well, whereas it was symptomatic of degeneration into a Ponzi scheme- MN). The reasonable expectations of policyholders at any given time would have been that the pattern would be sustained in the reasonably foreseeable future in the absence of financial catastrophe. Had the Society recognised terminal bonus in its statutory accounts and regulatory returns on any basis consistent with PRE, its financial weakness would have been exposed throughout the 1990s"(P14.186).

More specifically, while summarising Ranson's role, in chap 19.128 Lord Penrose says: "In relation to the Society's regulatory returns, Ranson did not apply successive regulatory requirements requiring the valuation of

Guarantees explicit on the face of the with profits pension business; and

Any options that were from time to time in the money, relative to the Society's primary obligations

As a result, the Society's regulatory returns failed to identify and value the growing guaranteed obligations that resulted from a combination of falling interest rates and lightening mortality experience. Such references as were made to these guarantees in and after 1994 (relevant to the 1993 return {i.e. when the DTBP finally emerged after 10 years below stairs- M.N.}) failed properly to disclose their nature and extent to the regulators."

In chap 19.147 Lord Penrose concludes: "In the case of the Companies Act accounts there was a failure to identify and to quantify in an intelligible way differences arising from changes in assumptions, and a failure to relate the consequences to PRE. In particular, between 1990 and 1997 (which the writer takes to be for the years 1989-96, i.e. from the official start of WPWM until the end of the GIR period) the Society's published financial statements failed to inform policyholders of the analysis of the movements in value resulting from changes in actuarial assumptions, and failed to draw attention to resulting discrepancies between the policy values intimated to them and the relative liabilities reflected in the accounts". In other words, there was persistent non-disclosure of crucially relevant information to policyholders, let alone risk-carrying mutual society owners who had every right to it.

It has previously also been shown that C.S.S. Lyon's "moral charge" was effectively made a real one by Ranson and Headdon's statement in their WPWM paper to the effect that, since the Society's practice was to pay out policy values in full, then the relative proportion of the guaranteed and un-guaranteed elements was of minor importance (R & H section 3.2.6; EARW section 5 p 12). Of this Lord Penrose says: "…That representation was consistent only with a bona fide intention to pay a final bonus according to current market conditions and the stage in the Society's smoothing cycle, if there were a relevant smoothing policy…" (P19.78). And yet in discussion of the Edinburgh reading of the paper in 1990 Ranson had belied this statement by saying: "…In practice, we also pay full value on withdrawal and surrender at any time. That is not guaranteed and that could be the first thing to go if things got difficult…" (EARW p 9). But at the same time "Ranson did not advise the Board of the risk that persistent practice associated with published statements of practice would develop policyholders' reasonable expectations (PRE) that existing patterns of payment would continue to characterise the Society's bonus practice in the future. In particular the advice that future terminal bonus payments were not guaranteed (that is not contractually due) diverted attention from the risks associated with the generation of non-contractual expectations of future bonus payments" (P19.121.) Where, then, was the good faith? And how is all this to be reconciled with the prior covert existence of the DTBP?

The expression "policyholders' reasonable expectations" (PRE) first appeared in Ronald Skerman's paper *A solvency standard for Life Assurance Business*, published in 1966. His reference to PRE came in his discussion of the essential characteristics of with-profits business and of his five principles of valuation (P13.34). Skerman's paper identified three problems, of which the third was: "Participation in profits. Holders of with-profit policies have taken them out in the expectation that they will benefit from a share in profits from time to time. Although an office is not under a contractual obligation which can be quantified in relation to the benefits which its policyholders will derive from future profits, it would be unsatisfactory not to take some account of the policyholders' reasonable expectations when determining the value of the liabilities." Lord Penrose says*:* "Skerman identified the expectation that concerned him: the expectation of benefit from profits arising from time to time. He thought that the valuing actuary should have regard to the reasonable expectations as to participation in future profits in selecting the method used in determining the value of liabilities. His five principles were elaborated against that background (P13.35)".

In ¶ 37 Lord Penrose observes: "Skerman was not concerned with the content or meaning of the expression "policyholders' reasonable expectations". He was concerned that the actuary should have regard to the reasonable expectations as to participation in future profits in determining the value of the liabilities. That required the adoption of a valuation method that

avoided setting off against current liabilities that part of the future flow of premium income that was not related to guaranteed benefits, so leaving surplus generated by that part to emerge over the duration of the contract and to create the bonuses that policyholders reasonably expected to emerge in parallel with it". But, at the Equitable that surplus, plus the prior estate and a charge raised against the future had been "deliberately" distributed elsewhere.

"The prospect of failure to meet the "reasonable expectations" of policyholders and potential policyholders was introduced as a trigger for regulatory action in the Insurance Companies Act of 1973 sections 12(1) and 21. The expression was not defined by Parliament" (P13.9). "The provisions as finally enacted in 1973 were consolidated in the Insurance Companies Act 1982, sections 37(2)(a) and 45(1)(a)" (P13.40). All five versions of the Faculty and Institute of Actuaries Guide Note 1 (GN1) issued over the period 1/05/75 to 1/09/96 make reference to the above provision in the 1973 and 1982 Acts, and the resulting duties of appointed actuaries in regard to them. This included advising their companies on relevant contributory factors, and from version 2 onwards their own interpretations of policyholders' reasonable expectations (P13.57-94). Furthermore, "…It may be appropriate to note that paragraph 2.3 of GN8, from 1994 onwards, mentions that the appointed actuary would be expected to make investigations in order to be satisfied that the long-term fund was able to support a proper level of future terminal bonus having regard to the bonus smoothing policy followed by the office…"(P6.111. See also EARW section 5 p 11).

With this summary in mind, it is relevant that the earliest comprehensive written presentation on PRE was made to the Equitable Board by Headdon on 26th Nov 1997, i.e. not until both Sherlock and Ranson had retired (P14.1). Lord Penrose comments (¶ 3): "The broad statement in paragraph 8 stated that PRE was a function of the policyholders' response to what was communicated by the office about the management of the business is incomplete. But, even on that basis, distribution policy would be an <u>aspect</u> of PRE, but not the <u>measure</u> of it. Further, as appreciated by the departmental officials in discussing PRE, the regulator may become aware of facts and circumstances that had not been communicated to policyholders in any way, but that might threaten the office's ability to meet reasonable expectations. In his analysis Headdon gave inadequate weight to the conduct, as distinct from the comments, of the Society as a factor contributing to PRE. But the statement provides a valuable insight into the understanding of the Society's staff of the requirements derived from policyholders' reasonable expectations, both generally, and in relation to participation in surpluses. It was also an explicit acknowledgement of the appointed actuary's responsibility that had no real precedent in the Society's practice". As to why the presentation may have been made to the Board, Lord Penrose says in ¶ 4: "This report was presented a few months after Headdon had advised Nash of his analysis of the Society's past over-distribution and of his view that it would take some fifteen years to achieve equilibrium. That analysis of actual experience was not reflected in the advice".

When it comes to the specific issue of the GAR, it is sufficient to quote from Lord Penrose's analysis of the Society's communications on PRE and bonus: "But, given the Society's advertised commitment to openness of communication, there was no basis for a reasonable expectation that the Society had created a potential conflict between guarantee annuity policyholders and other with-profits policyholders (P14.13)" – and: "But so far as the new personal pension policyholders are concerned the search by the inquiry for an indication that there might be an adverse impact on policy proceeds arising from competition between classes has been in vain" (P14.69). This is also, of course, an inherent characteristic of general mis-selling by the Equitable (vide infra)-a conclusion that the PR refrains from making.

As initially explained, the primary purpose of this article is not examination of the regulatory position. But with regard both to PRE and the official Opposition case for organisational and operational regulatory failure, readers are invited to consider the PR's extensive quotations (P chap 13.107-12) from a memorandum dated 21st Sept 1987 by George Newton, who was directing actuary for the insurance directorate at the Government Actuary's Department (GAD) from 1982-8. Newton clearly described a desired and responsible regulatory position despite contemporary uncertainties over the definition and importance of PRE. Some of his specific concerns were highly relevant to the Equitable; readers are invited to consider

whether history has since proved him right. As they read the next two sections they are also invited to consider whether there is or is not always a hard and fast distinction between conduct of business and prudential regulation, and the extent to which both underpin the concept of PRE.

*Regulatory Failure I: Conduct of business:*
*"Incentivised Ignorance" and fraudulent general mis-selling- how and why it was denied by the Society and then deliberately overlooked by the regulators, Treasury and the PR.*

The Aylesbury senior management team included sales and marketing personnel. Consistently with the importance of the sales drive, marketing director Ken Wills, who had been recruited by Sherlock, joined the board as an executive director as early as 1976. The natural expectation would be that the material events of 1982-9 should have been included in the relevant policy documentation or in promotional material. But if the Board of Directors had not been adequately informed it is hardly likely that the rank and file of the Society's branch office staff, agents and field force would be told, let alone potential policyholders and members. In fact, every policyholder's sad experience is that this was never done, and to the writer's knowledge every salesman's reported or broadcast statement has been to the effect that they did not know either. And despite what the Society told policyholders about the absence of commission fees, it paid its staff an as yet unspecified commission on sales. Nor do we know whether the commission was the same for all the Society's products, or if it was greater for with-profits products. But whatever it was, surely it acted as a motivating and otherwise influential incentive for sales staff.

Even before the House of Lords decision in the *Hyman* case which finally made it essential, policyholders' common experience indicated that there was a quick and inexpensive way of cutting to the chase, and establishing the essence of what had gone wrong, and when. A handful of experienced regulatory and forensic investigators could have tracked back from a representative sample of policyholders, through their salesmen and a sufficient number of branch offices, to the hierarchical level in the executive function at which ignorance of the critical factors began. Persons above that level would have been material to fraudulent non-disclosure and misrepresentation. Had this been done, much lengthy uncertainty, and perhaps even much of the Penrose Inquiry itself, might have been avoided. Unfortunately nothing of the sort happened then or since, and so it remains unclear whether departments and persons other than in the actuarial function were involved.

For these reasons, and in an effort to ensure that the Compromise Scheme did not later come unstuck by failing to take the matter into consideration, the writer had laid out the case for general mis-selling and hence establishing the level at which "incentivised ignorance" began in a letter to the Society. The case remains unanswered. The matter now becoming urgent as well as grave, an evidential paper entitled: "The Equitable Life Disaster-does it compare with the Lloyd's asbestosis scandal of the 1980's?" (ELD) was twice sent to the FSA, and when they failed to acknowledge it to FSA chairman Sir Howard Davies. Sir Howard Davies personally acknowledged receipt of the paper, but did not act. ELD also went to Opposition Treasury Spokesman Christopher Chope via the writer's MP Alan Duncan. In due course Mr Chope asked from the floor of the House of Commons what effect class actions for general mis-selling might have on the Compromise Scheme, but he too received no answer from Treasury spokespersons.

After the Compromise had gone through, the writer sent ELD and relevant correspondence with the Society to the Penrose Inquiry. Receipt was acknowledged, in spite of which the PR does not cover Conduct of Business or any analysis of the Society's promotional material or sales platform- a fact that must be re-visited shortly for other reasons. Likewise it makes little attempt to address common factors in what policyholders were or were not told by their sales representatives. Not having addressed a common factor (such as mis-selling involving non-disclosure of inequities of guarantee and hence the impact of the GAR and the DTBP) and traced its origins, the PR can say nothing about the role of the sales and marketing departments in the critical events of 1982-7, or indeed later.

Later still, as related at the end of EARW section 11, the writer foresaw that the Society might delay making cuts in FSAVC annuities until the government FSAVC review was complete. He forewarned Sir Howard Davies' Office and the FSA, who offered no opinion and did not intervene.

Tedious and personal though it is, this list of informed and elective omissions by the Society, regulators, Treasury, the Financial Ombudsman Service and the PR is a point worth labouring. By refusing to admit or document general mis-selling and non-disclosure, the Society and the authorities have transferred the burden of proof to each individual policyholder. The individual burden of proof is implicit in the "lead case" explorations of policyholders' situations adopted by the FOS, and now proposed by the Parliamentary Ombudsman. Of necessity this can also limit what can be discussed to individual circumstances- which is rather like a random gathering of pieces of rotten flesh and broken bones, but affecting not to see the dead elephant unless or until the full anatomical inventory is absolutely complete. Because they have refused to look, the authorities can thus continue to maintain that there is no evidence for any form of underlying general malfeasance. Without official substantiation of general harm or malfeasance where can be the originating fraud? Under these circumstances it is hardly surprising that the FSA has belatedly said that it has conducted its own investigation and found no case for mis-selling by the Equitable, while refusing to publish the evidence. In effect the FSA is claiming to have proved the impossible, which justifies giving the wrong answer long after the right one was really needed. Like the Equitable with-profits fund, the FSA has become its own opposite. In that this can be anticipated to exert pernicious influences on the working of other subservient bodies such as the FOS (Financial Ombudsman Service), it must now be guarded against.

The benefit of labouring the point is finally clear. The list of elective omissions denotes regulatory failure before and after the Compromise, which was and remains knowingly deliberate. Understandable though the pressures on the Government, specialist bodies and regulators are, the implications for our constitutional and national life are far-reaching. But despite all it is now evident that here was no fruit on the tree, and that the branches were limed. More than a million trapped birds are learning what bound them, and so it is only a matter of time before the defensive position breaks. We must prepare for the consequences as best we can. Meanwhile some trapped birds have turned woodpecker, and attacked the tree with group legal action. Because there is no statute of limitations on fraud, there will be time enough for yet more birds to learn the trick and develop it further as reports of its success grow. Carried to its limits this can only lead to disaster, but as ELTA chairman Peter Scawen has pointed out, it is presently one of the few realistic ways of cracking the whole defensive edifice and forcing a more constructive reappraisal.

*Regulatory Failure II: Prudential.*

The evidence presented in the different sections of this paper is here brought together to support the itemisation of prudential regulatory failure which now follows. Much of it has also been submitted by ELTA and ELCAG (Equitable Late Contributors Action Group) to the Parliamentary Ombudsman's second inquiry. It is instructive to compare the list with the Official Statement of Complaint which has appeared on the PO's (Parliamentary Ombudsman's) and EMAG's websites. Much credit is due to EMAG for the latter, because in the second round of negociations with the PO's office they reformulated much of what had transpired in the first round in a publicly and politically acceptable format for the PO's second Inquiry. However, such considerations are secondary in a paper of this sort.

The authorities responsible for the prudential regulation of insurance companies (successively the Department of Trade and Industry, Her Majesty's Treasury, the Security and Investments Board, the Personal Investment Authority and the Financial Services Authority, collectively referred to in the rest of this section as 'the regulators') failed properly to exercise their regulatory functions in respect of the Equitable Life Assurance Society (ELAS).

**The Primary Failures**

a. It must be noted that the normal situation of Regulation, is that it oversees and checks upon actions already taken by the management of life assurance companies. Where harm occurs to policyholders, actual or potential, the harm is caused by companies themselves and that harm is then compounded by the failure(s) of the Regulator. The evidence gathered and set out in Penrose, and subsequently extended in this paper and elsewhere, indicates that the primary causes of the claimants' losses were inequitable dispersal of the Society's traditional estate followed by deliberate over-bonusing over the years 1982-1986/7 which progressively increased contemporary realistic liabilities from a situation where they were in some degree of balance to one where those liabilities totalled £4.5-5.0 Billion, against assets of £3.0 Billion.

b. The Regulators did not intervene in any effective way, although they should have known that such over-bonusing would have the following inevitable effects:

- Early claimants would take substantially more than their fair asset share from the WP Fund;
- Those benefiting from the over-bonusing would retain a larger claim on the WP Fund than their asset share would justify;
- Those early claimants would drain capital from the Society, where that capital was properly required to service remaining policyholders and to maintain solvency;
- Remaining policyholders would be deprived of their fair asset share;
- The size of the effective asset shortage would increase in line with the allocated 'investment growth' of the Fund, unless steps were taken to negate the over-bonusing in one way or another. In effect, therefore, a permanent rather than intermittent or temporary strain on the Society's finances was allowed to accumulate.

In other words, the Regulator, by inaction, allowed the Society to be put in grave solvency peril, both in immediate terms (for example see Penrose on the situation in 1990-92 although not covered here), and in constructive terms by giving new cohorts of policyholders valid grounds of claim against the Society.

c. With each passing year, a greater volume of losses was crystallised in claims, until by the end of 2000, such losses probably exceeded £8 Billion. On any reasonably informed analysis it was these losses and the resulting capital shortage which prevented the sale of the Society as a going concern.

d. As a further consequence, new policyholders were recruited on a basis where they shared in a substantial undisclosed deficit sufficient to undermine the viability of the Society, and they thereby received substantially less than their proper investment growth. However, this deficit was concealed until the Society's Ponzi operation effectively collapsed with the total policy value cuts of 16 July 2001, whereupon the entire deficit fell upon the shoulders of those policyholders who were still with the Society on or after that date.

e. In conclusion: The claimants' losses flowed primarily from reckless behaviour by the Society's management which over the period 1973-1987 had critical consequences. This behaviour was of a kind which fell squarely within the scope of the Regulator's duties and powers to monitor, warn and compel retraction. The Regulator took no action or no effective action and allowed actuarial etiquette to guide its conduct instead of statutory duty. As a result the Prudential Regulator became equally responsible for the losses in question.

**A. Organisational issues**

a. The regulators were not always sufficiently resourced, and did not all possess the necessary skills, to make an effective contribution to the regulatory process and responsibly exercise discretionary powers as intended by Parliament from 1973 onwards. As a consequence they did not properly undertake their functions.
b. The prudential regulators failed to communicate effectively with those responsible for the regulation of the conduct of business by insurance companies, particularly in relation to ELAS' published actuarial and insurance business paradigm, or to advise

the Conduct of Business Regulators that the realistic position rather than the Solvency position was the primary reference for potential customers, or in regard to changes in policy forms and the guarantees provided in accordance with this or annual statements and letters to members.

c. Although ELAS were aware of the significance of non-guaranteed bonuses and showed them in their 'Office Account', the Regulators did not give the matter proper attention despite its importance for policyholders and for the financial viability of the Society

d. The regulators and GAD allowed successive chief executives/managing directors of ELAS also to hold the post of appointed actuary, despite a recognition of the potential for conflict of interest in this position, and the fact that it completely undermined the basis of the regulatory process which was founded on the separation of powers between the AA and the rest of the Executive.

**B. Operational issues**

As a general point, the regulators spent over-much time debating the circumstances under which they might use their discretionary powers, and in the event never used them when the overall situation required them to do so. As a result they did not recognise or react to any of the important successive stages in the development of that position, which were:

a) From 1973 onwards the regulators failed to react to ELAS making no explicit reservation for its increasingly dominant bonus form (terminal bonus), and did not examine the position from the realistic aspect required under a proper or reasonable interpretation of PRE.
b) When in 1987/8 ELAS carried over into new policy forms a bonus record enhanced by the prior dispersal of its estate which had no prospect of continuing, it began trading on a false basis. Regulators could and should have recognised this at the time, because the Society had also moved into over-allocation. More seriously from the prudential aspect, the over allocation to the pre-87 policies was of such magnitude as to drain capital required for solvency within a few short years. Nevertheless the Regulator did not intervene.
c) Despite contemporary informed actuarial comment the regulators failed to scrutinise the "With Profits Without Mystery" actuarial and insurance paradigm. Had they done so, they would necessarily have discovered that it was in essence a post hoc sophistry-laden rationalisation for dispersal of its assets, and running a with-profits fund on an intermittently negative technical solvency gap. Under the WPWM paradigm and/or given the Society's underlying situation there was no prudently equitable assurance, or real prospect of fulfilling policyholders' reasonable expectations.
d) From 1987 onwards the regulators allowed a with-profits fund to operate on a mostly negative technical solvency gap which betokened liability for present and future policyholders rather than profit.
e) The regulators generally failed to appreciate the effects of conflicts of interest between the Society's private and corporate/institutional clients, and the GAD's position in recommending the Society as a civil service institutional pension scheme provider.
f) Despite helping to develop joint "net premium" and "gross premium" actuarial methods to probe ambiguities in hypothecation of assets and liabilities under different accounting and regulatory return conventions, the regulators did not use them on ELAS's returns. Had they done so, the fundamental weakness in ELAS's position would have been exposed by 1996/7 at the latest.
g) Having turned a blind eye to gross solvency risks in 1990-92, the Regulator adopted thereafter a self-protective policy of denial, to conceal the maladministration that had taken place in previous years, and to absolve itself of responsibility when the collapse of the WP Fund eventually manifested itself. It colluded throughout the period 1996-2002 in attributing the circumstances leading to the closure of the WP Fund to problems with Annuity Guarantees, rather than the earlier and far more serious over-bonusing of 1982-87.

h) The regulators failed to follow up disclosure of the Differential Terminal Bonus Policy on Nov 30th 1993, or assess its implications for regulatory solvency and PRE. Had they been sufficiently diligent to trace the origins of the DTBP at that time, they would necessarily have concluded that its prior non-disclosure was fraudulent.

i) The regulators failed to question why the Society inappropriately extended its chronic over-allocation by using inappropriate quasi-Zillmer adjustments and subordinated loans which anticipated future premium income and impacted adversely upon future profits. As a result they failed to digest the prudential and PRE implications.

j) Understandably, the regulators could not detect that the reinsurance arrangements made to cover the Hyman position were a show treaty without substance. The regulators did not, however, examine ELAS's public statement in Feb 2000 that losing Hyman would cost members no more than £50 million, when reinsurance to the tune of £800 million was nominally being sought to cover the same situation. At the same time the Society's actuaries were valuing a "worst case" scenario based on 100% GAR uptake at over £3 billion. These disparities demanded rigorous investigation.

k) Despite external representations and their own evidence to the contrary, the Treasury, judiciary and regulators, and in particular the FSA, supported ELAS's position that there was no generic mis-selling of policies in respect of the GAR liability, and that ELAS's problems were solely due to the GAR liability. On this public position the Compromise Scheme of arrangement was carried through to the detriment of members and with forfeiture of their legal rights.

l) In so doing, Treasury and the regulators necessarily permitted carry over of ELAS's discredited WPWM fund paradigm and structure by the New Board under circumstances in which with-profits fund status was irretrievably lost. They also allowed cuts in policy values well in excess of the nominal GAR liability without questioning their rationale, and without requiring any action to undo the over-bonus on outstanding GAR policies dating back to the 1982-86 era, which had become ever more substantial with the passage of time. Furthermore, if the Regulator had insisted on truly prudent action at that time or earlier, all final (i.e. discretionary) bonus would have been suspended indefinitely until the financial condition of the Society could be fully established, thereby retaining a vital £2 billion of capital which was subsequently lost.

m) After the Compromise and despite forewarning, the FSA allowed the Society first to raise FSAVC's in compliance with FSAVC review procedures, and then cut them again immediately afterwards along with deferred cuts in all other annuities. In effect, therefore, the FSA permitted the Society to make post-Compromise upward revision of FSAVC's which it knew the Society had no intention of honouring.

In sum, therefore, there is sufficient evidence to maintain that operational regulatory failure was total over an extended period, and that in the later stages it was deliberate, such that it had the effect of extinguishing many just claims without opportunity of recompense. Had the regulators halted this progression, an eventually fraudulent position would have been averted, which effectively they condoned by allowing the Compromise Scheme to take place. The writer is moreover confident that total operational failure of this ultimate kind can only be due to an overall deficiency in ethically responsible attitude. Others have wished further to maintain that, over and above organisational and operational deficiencies, regulatory failure must also have been collusive.

**C. Payment of excess bonuses**

a. Over a period of many years the regulators and the Government Actuary's Department (GAD) permitted ELAS to declare bonuses in excess of available assets, while at the same time operating without a significant estate. This was a major contributory factor in the Society's demise and in the losses incurred by all those who held policies on 16 July 2001.

b. Over this same period, the regulators allowed ELAS to publish financial results and projections that were misleading in that they did not reflect the Society's true position.

**D. Issues relating to regulatory solvency**

a. From about 1990 onwards the regulators and GAD failed to give sufficient consideration to the fact that a number of the various measures used to bolster ELAS' solvency position were predicated on the emergence of a future surplus (for details see operational factors above). As a consequence, they did not properly assess the overall impact and adequacy of those measures.

b. During the same period, the regulators and GAD failed to act when ELAS adopted what Lord Penrose described as practices of 'dubious actuarial merit'. These included valuing future liabilities at an inappropriate rate of interest between 1990 and 1996; treating selling costs as an asset; making no provision for guaranteed annuity rates until much too late; valuing a financial re-insurance policy which proved to be useless, at over £800 million; and taking on a subordinated loan which was not counted as a liability.

c. On several specific occasions the regulators and GAD ignored or failed to action information that might have led to regulatory action against ELAS.

d. The regulators and GAD further failed to assess whether the New Board's representation of ELAS's situation was full and fair in the run up to the Compromise, and in the light of their own expert knowledge whether that description was consistent with PRE.

e. In July 2001 the regulators allowed the Society to boost regulatory solvency by making total policy value cuts that included the guaranteed portion of members' funds. *De facto* this denotes breach of guarantee and regulatory insolvency, and is also a flagrant violation of PRE. By any ordinary criteria regulatory approval of such a manoeuvre is astounding.

.

*Fat cats and poor mice, or further inequities in conduct of business.*

It has thus been possible to look under the veil that the PR and the regulators left in place over the conduct of business, and see what affected many individual policyholders. We have also seen that longer-term policyholders were consistently awarded greater returns, which for the increasingly dominant terminal bonus allotment was greatest over the years in which the estate was dispersed. But that does not conclude the matter. The Society's problems might ultimately have been less serious had not the Trustees of the various pension schemes insured by the Society insisted that they be allowed to retain the GAR pensions for a further five years when the Society attempted to withdraw them in 1988. Hence new scheme members enjoyed the relative advantages of GAR status for five more years, while it was denied to private members. This is a serious inequity, of which the Society, scheme administrators, their consulting actuaries and trustees must often have been aware through their special knowledge and expertise. The granting of this privilege would also have made any declaration of a DTBP within the grace period most unwelcome, such that it too had to remain secret for a further five years until 1993. The effect this had on the Society's finances hardly needs spelling out- and the resulting burden fell most heavily on the post-1988 private policyholders, all of whom were non-GARs. How and why was it allowed?

Since the Society's problems stemmed in part from the threat of losing its institutional business, there would have been a need to retain, replace or extend it. How was this done, and what was involved? If there was little in the PR on conduct of business vis-à-vis individual policyholders, on this aspect there is nothing, although some interesting questions arise from the Society's attempts to consolidate the retention of as much FSSU business as possible over the 1977-9 triennium. What was there in the regulations to safeguard the equitable interests of less well-informed private policyholders against the interested advantages enjoyed by companies and institutions? How was that duty observed by the Old and New Boards of Directors and by the regulators? And was it one that either Board of Directors should have recognised? To all these questions there is as yet no answer.

This was not the only occasion on which such questions were relevant. As the Compromise approached, at least some scheme trustees and their consulting actuaries negotiated mass exits from the Society in exchange for a 5% reduction in their members' total policy values. Individual policyholders were less fortunate; they had to forgo 10%. Corporate and institutional clients could thus escape with a considerably lesser penalty; meanwhile Law Debenture Pension Trust plc, as the Society's proxy Trustee for free standing AVC policyholders and the Society's annuitants in the Compromise vote, delivered them into the Compromise. Similar situations, therefore, but different outcomes depending upon Trustee interests?

Clause 2f of the Parliamentary Ombudsman's Statement of Complaint for the Second Equitable Life Investigation adds a significant further dimension to these considerations. For this we have EMAG to thank, and it reads: "GAD had recommended ELAS as a pension plan or additional voluntary contribution provider in its advice to the administrators of the Principal Civil Service Pension Scheme and to other public sector pension schemes. This led to a lack of proper separation of its responsibilities and to a clear conflict of interest between GAD's role in providing advice to government bodies in relation to public sector pensions and in assisting the prudential regulators of ELAS. This conflict of interest compromised the proper discharge of GAD's regulatory functions." In the present context there is no further need to elaborate on why this is deeply worrying, but it is worth pointing out that the context is itself a useful framework for any relevant additional investigation.

So at last it emerges that at various times and in different ways scheme members and those with expert or inside knowledge and connections have fared better than individual policyholders. In fact, there is a need to know how much this amounted to and agree the forms it took before any definitive explanation of how the Society's funds were dispersed can be accepted. If the Penrose, Baird (Equitable regulatory) and Corley (Equitable actuarial) Reports have not raised and dealt with the matter, it may also transpire that the ongoing Morris (general actuarial) Inquiry does not have the remit to tackle it. Indeed, the writer finds

it hard to see how the relevant questions can be answered without further regulatory and forensic investigation. Since the authorities have already deliberately elected not to conduct such a systematic investigation into private policyholders' complaints, the possibility of a necessarily more rigorous investigation on the corporate, civil service and institutional front seems remote unless more forceful representations are made. Such representations are unlikely to come from the institutions, government and specialist bodies, corporations, trustees and actuaries themselves, and so private members must look elsewhere. They must also trust that old allegiances do not similarly inhibit the Opposition from assisting them further.

*Finale: Cipher, crib, key and message.*

Close poring over the cipher, crib and contributory material has yielded both the key and a message. The key turns out to comprise instrumental members of a senior management team in their central executive position. As the Society grew, that position became consolidated into an autonomous power base that was not properly accountable either to the Board of Directors or the Society's owners and members. Their leaders maintained that the Society's actuarial and business paradigm, design of a complex heterogeneity of investment products, the keeping of Companies Act and regulatory accounts, product particulars and the sales platform were properly executive and professional matters and not primary responsibilities for other members of the Board. In due course they similarly assumed responsibility for risk management over the years 1993-2000, which in theory included the policing of their own activities, but in practice was used to ensure that their tactical plans and version of events were followed. Such information as they imparted to the Board was of an incomplete, discontinuous and fragmentary nature, and in respect of items relating to policyholders' reasonable expectations was not statutorily compliant. The resulting situation is not entirely unique, and its common elements have recurred more than often enough elsewhere.

At the same time, the growing size and importance of the executive function and modernisation of the Society's corporate governance led to more team members becoming executive directors on the Board. The necessary increases in prestige, prospects and power must have been a spur to the ambition of more senior executives. As in many management hierarchies, upward progress may have depended on feudal allegiances and evidence of loyalty as much as upon ethical and professional competence. The feudal pyramid once climbed and a directorship attained, a larger landscape of opportunity with wider horizons appeared. The new vista held temptations as well as more weighty duties and responsibilities, because further success now depended upon pleasing the non-executive directors and the Society's more influential customers. Grace and favour appointments such as Sherlock's inaugural chairmanship of LAUTRO (Life Assurance and Unit Trusts Regulatory Organisation) beckoned. From current knowledge, leadership succession and instrumental team membership appear consistent with feudal lineage.

If the key comprises characters and their motives, attendant circumstances composed the message. Understanding the message involves following the chain linking causes to effects either from the top downwards, or from the bottom upwards. The "top down" approach is central and organisational; this the PR has done well, and mostly well enough for it to complement prior findings in EARW and a "bottom up" approach based on examination of the details of conduct of business, and its effects upon customers. It is thus most unfortunate that external constraints have caused the PR to be very sketchy on the "bottom up" approach, which of necessity means that some important details in the middle of the chain are still missing. As we have seen, for similar reasons there has been no help from the Treasury and regulators in elucidating the essential common features revealed by a "bottom up" approach, but in spite of all there is sufficient emergent consensus among individual members, policyholders, action groups and class legal actions to determine what they are. From it their universality can be deduced, and this in turn means that local branch offices and the Society's field force must have operated in a state of "incentivised ignorance". These surmises have variously been and continue to be substantiated or confirmed, and so now they track back to more senior echelons in the management structure. Though it seems inherently likely that

very senior sales and marketing personnel were material to the situation, the PR does not tell us whether they were also instrumental team members who were party to critical knowledge withheld from Board, members and regulators alike. Meanwhile it seems relevant that from 1976 onwards marketeers were also executive directors.

We do, however, know that at least one other instrumental member of the senior management team was not a qualified actuary. He was co-inventor of the discredited WPWM actuarial and business paradigm, who under the circumstances improperly assumed responsibility for risk management in 1993. Otherwise, apart from the actuaries, it is unclear who the instrumental members were, how membership varied after 1982, and what might have been the extent of Sherlock's own involvement. Until we know, it is unwise to speculate upon the cameradie, personal loyalties and even friendships which may have come to bind it together over and above original feudatory allegiance. Somewhat perversely those bonds may have included an initial sense of loyalty to the Society, and via misguided attempts to save it have led to its founding principles, reputation and product base being first entirely traduced and then betrayed. Similarly, there is no inkling as to whether outsiders became affiliated to the instrumental group. Considerable importance attaches to the answer because of the Society's perceived need to chase corporate and institutional business, with all the adverse effects it has had. This the PR has failed to address, and so as with private policyholders, the "bottom up" and "top down" details of the process remain officially unknown. But as explained, the resulting inequities that have so far surfaced are very serious, such that they and the relevant regulatory environment must now be explored.

The succession of events leading to the Society's increasingly desperate straits, its descent *via* innovative expediency into bad faith, and a decade of increasingly serious non-disclosure of critical background information which by 1987 had become fraudulent has been chronicled. History has also revealed that a definitive blueprint for traducement was written within, between and even behind the lines of the 1989/90 WPWM manifesto paper successively read to the Institute and Faculty of Actuaries. The sophistry-laden paradigm it described was a *post hoc* rationalisation of the inequitable dispersal of the Society's free assets, which had occurred during an ill-judged attempt to retain existing business and expand, and which became seriously disrupted by the immediate turmoil and inflationary after-effects of the 1973 oil crisis. If that were not bad enough, the paradigm also fallaciously sought to justify crossing over into over-allocation. Moreover, because what was then also known and not disclosed included a contingency plan which nullified its central undertaking, the paradigm was uttered in fraudulent bad faith. And once over-allocation had been extended by technical devices which eroded solvency margins, and loans or adjustments which inappropriately anticipated future income, the Society's fate was sealed and ultimate betrayal became inevitable. The with-profits fund thereby degenerated into a modified Ponzi scheme levered off the dominant un-guaranteed fraction of policy values, and ended in the usual way. In the course of it a minority of earlier members received substantially more than their fair share, and the great majority of later members paid dearly for the consequences.

So much for the poachers, but what of the gamekeepers? First we have seen that, in considering conduct of business and prudential regulation in relation to emergent viewpoints on PRE, outgoing Insurance Directorate Actuary George Newton had by 1987 clearly identified and drawn attention to the major problems that were later to affect the Equitable, and that following his departure his advice was ignored with disastrous consequences. On the one hand this is retrospectively inexcusable, and on the other it is ironic in that 1987 was also the year in which the Society definitively crossed over into fraud. Hence, notwithstanding the organisational deficiencies which led to co-operative failure of the prudential and conduct of business regulatory arms identified in the Baird Report, there must also have been a more fundamental problem of responsible attitude. This has been reflected in the Opposition stance on prudential regulatory failure, and in the depositions by the action groups to the Parliamentary Ombudsman. Now we may also reasonably infer that similar attitudinal problems could underlie the informed and deliberate failures in both prudential and conduct of business regulation by the FSA to which attention has previously been drawn. With this knowledge, and in revisiting the axiom that: "No regulatory apparatus can function any better than the milieu in which it operates", it was earlier found helpful to distinguish between deficiencies or failures of organisation and resources ("systemic factors"), operational factors,

and those arising from individual or collective stance and attitude. And the unpalatable fact is that regulatory failure has been total from 1973 to the present day. That always was, and has over-long remained, a profoundly serious matter.

It is thus only a matter of time before the whole situation becomes more widely understood and agreed. Beyond that point the carefully constructed defensive positions of the Society, Treasury and regulators can no longer hold. All the interested parties will then be much exercised, and if disaster is to be avoided they will at long last be compelled to co-operate openly and constructively in a climate of common understanding. Without wishing to pre-empt that co-operation, the writer believes that one rallying point for it may be the granting of a "virtual estate", in order to underwrite a less defensive investment strategy and thereby restore with-profits status to the Society's remaining policyholders. As and when policyholders die out, the residue of the virtual estate would revert to the underwriter. Since inflationary pressures are again mounting, something of the sort will become increasingly necessary. Under the circumstances it may not be unreasonable to ask the Government for underwriting assistance. That said, Chancellor Brown's roughly £500 million hole below the Society's solvency waterline is another obvious rallying point. Holding the balance will demand overall fairness and a reasonable degree of sympathetic restraint from the action groups.

Without reasonable co-operation the Government's hand-washing of any responsibility for regulatory failure, and its more deliberate aspects in the irregularities surrounding adoption the Compromise, will both come in for increasingly critical appraisal. And if the Treasury and the regulators continue to act inappropriately, ultimate responsibility passes to the First Lord of the Treasury and Minister for the Civil Service in the person of the Prime Minister. If he in turn fails, then remedy will be sought in Europe and through the courts. But whatever the outcome, so great has been the damage that it is hard to see how the political reputations of the Chancellor of the Exchequer and ex-Treasury Minister Ruth Kelly can survive it. On the Society's side of the fence the New Board can expect more grilling on how the reality of the Compromise squares with their prospectus, the Society's true financial position in consequence, and on the balance of their representation and guardianship of the interests of different classes of policyholders or private versus corporate/institutional members.

The handling of the Equitable Life crisis, rather like that of the Second Iraq War, has been one of the defining issues of our times. We should with reason fear that, unless the profound malaise in public life that they have revealed can be contained or cured, English parliamentary democracy may not last a thousand years.

Dr. Michael Nassim. December 30th 2004

**Level 3: The Evidential Base.**

**Scope and Limitations of the PR:**

2. As anticipated (EARW Section 12 p21), in his opening letter to Financial Secretary Ruth Kelly (i – ii) and introduction (viii - x) Lord Penrose has been obliged to qualify the terms and scope of his inquiry. He had no formal powers, could not compel submissions or attendance, undertook to observe confidences and has not wished to compromise ongoing legal proceedings or tribunals.
3. Some of the resulting constraints are noteworthy and relevant. They include:
    a. Lord Penrose only covers events up to 31st August 2001 (P4.104). Hence there is not much of direct relevance concerning the nature and effects of the Compromise Scheme, or of the conduct of the Society, New Board, legislature and regulators in the lead up to the Compromise, or indeed its later consequences.
    b. The New Board did not support and assist the Inquiry for the period beyond 31st March 2001, and so the Enquiry could not go effectively beyond this earlier date (ibid), or indeed for any of the 8-month reference period in 2001 in any great detail (P4.105). As a result the New Board of Directors has not revealed its reasoning about the Compromise Scheme, or provided information about the state of affairs which it inherited when it took office. Such information is greatly needed in relation to matters discussed elsewhere in this paper.
    c. Lord Penrose has neither examined nor explained how the Society managed its conduct of business at the points of sale in its literature or approach to private members and corporate/federation scheme trustees. Policyholders' reasonable expectations (PRE) are relevant to both groups; prudential and solvency management are of added importance to the latter, besides underpinning PRE as a whole.
    d. Moreover the sales and marketing strategies for private policyholders and corporate/group schemes are different, and there are potential conflicts of interest between these client categories, generational cohorts, scheme administrators, consulting actuaries and trustees. <u>The circumstantial evidence is consistent with the Society having done overmuch to woo, win and retain important (but also influential) corporate/group clients, their administrators and trustees (cf. EARW Section 5 p12; et vide infra).</u> This is not covered, and so further information is required.
    e. Overall, Lord Penrose has felt obliged to indicate overall limits on the use made of his facts and opinions. For a comment on this see item 54 below.
4. An overall comment is that, as might be expected from its limited remit, the PR is much stronger on prudential and regulatory aspects than the conduct of business as governed by the Financial Services Act (1986). This is apparent in four ways, viz:
    a. it says very little about the evidence presented by individual policyholders.
    b. Analysis of the With Profits Without Mystery (WPWM) manifesto is centred upon financial strength rather than Policyholders' Reasonable Expectations (PRE), inequities of guarantee or duties of information.
    c. Lord Penrose is repeatedly careful to explain why he expresses no personal opinion on the issues of maladministration, negligence, breaches of faith and duty, non-disclosure, misrepresentation, deceit, mis-selling and fraud. He confines himself to discussing them only in a general way. In order to address matters more specifically he quotes from other relevant sources, e.g. the 1987 Newton memorandum (see 31 below) or the Glick & Snowden opinion to the effect that there were valid grounds to allege mis-selling. This may readily be confirmed by searching for these terms with Adobe 6.0. Other pertinent terms such as "deceit", "pyramid sales", "Lloyd's" and "Ponzi" receive no mention.
    d. Notwithstanding the fact that the Financial Services and Markets Act (2000) did not give the FSA statutory responsibility for insurance and conduct of business regulation until December 1st 2001, there is little criticism of the FSA

for its omission to supervise conduct of business by the Society prior to that date.

**Salient New Facts and Findings:**

**How, when and where did the Society's estate disappear?**

5. The PR's forensic accounting over the period 1970-2001 is very helpful and insightful, because it presents the salient developments in both narrative and tabular form. It broadly corroborates Burgess Hodgson's prior evaluation of the period 1990-2000, and provides important new information.
6. Prior to the inflationary 1970's gilts were a traditional safe haven, and the Society had not fully embraced the cult of equities. Servicing of its liabilities was based on interest earned from gilts, etc. It was very cautious about how to account for equity capital appreciation of its investments, and distrusted the inherent volatility of share valuations. Hence it was not initially disposed to regard such appreciation as a real asset, allowing only very small amounts onto the books periodically prior to the retirement of General Manager and Actuary Maurice Ogborn in 1972 (P chap 19.31). "In fact, the Society's reserves, in off-balance sheet capital appreciation and hidden margins in liabilities, amounted to over 40% of its long-term liabilities at the end of 1972, …" (P chap 19.8).
7. A significant new finding in the PR is that the Equitable had commenced building a strong sales function to offset the gap created by the disappearance of its Federated Superannuation Scheme for Universities (FSSU) business, complemented by a 5 year expansion plan beginning in 1973, i.e. shortly before the 1973 oil crisis emerged (P chap 3.16). It was thus committed, and adhered to, expansion at a time when rapid capital depreciation of its equity holdings resulted (for an overview of this and what it led to see EARW section 6 p 13). Even so, declared reversionary bonus rates were increased, because as Ogborn's successor Barry Sherlock later reported to the Board: "-if bonus had to be reduced the effect on new business would have been catastrophic" (ibid). This situation continued: "The decisions on interim bonus levels for 1974 and 1975 involved serious risk" (P3.29).
8. Again significantly, 1973 was the year in which Sherlock & Ranson first introduced the unconsolidated terminal bonus to supplant final annuity bonuses, and a "three call system" to allocated the surplus income generated by the equity component. Equity earnings were supposed to go three ways: **1)** as an equivalent amount to the yield of a comparable capital holding in fixed interest securities. **2)** a positive or negative adjustment to compensate for any difference that resulted, and **3)** allocation of excess positive adjustment as terminal or reversionary bonus. In practice, because of recurrent pressure to allocate bonus, negative adjustments to the second call were usually not made good, and the "three call" system was abandoned by 1984.
9. The "three call" system was immediately frustrated; there was no second call, and for the first time a significant proportion of any remaining capital appreciation (£12 million out of £30.6 million) was brought onto the books to support the first call. In addition, a terminal bonus rate of 10% was approved, which would have required an additional £ 12 million if fully reserved for out of the remaining £18.6 million, "-but the Board was advised that the actual expenditure over the following triennium was expected to be £1m. *It was to become a recurring theme of actuarial advice that terminal bonus was relatively cheap to service because the rate adopted did not impact on reserving requirements* (my italics)" (P3.15- the other many refs. are not enumerated). Indeed, the ratio of unconsolidated to consolidated benefits in policies came to be described by the aseptically euphemistic term "technical efficiency"- the higher the proportion of unconsolidated benefits the better from the Society's point of view. And by no means can it be true that that no provision need be made for terminal bonus. To say so was falsely reassuring, and it planted the fatal seed of bad faith which grew to destroy the Society, and all that it had previously stood for.
10. "By 1976, the Board had used almost the whole of the Society's inherited unrealised capital appreciation and the hidden reserves in liabilities to maintain competitive levels of declared and interim bonus at a time of market volatility. It had done so

without applying the prudent reserving policy it had accepted in 1973" (P3.38). This was despite bounce-back capital appreciation in 1975, and increasing the valuation rate of interest to reduce the value of the liabilities- a stratagem used again in later years.

11. The situation was now to be compounded by a prolonged period of apparent capital appreciation as a result of inflation, all of which was distributed to create an increasingly large bonus burden. This is well exemplified by the Penrose Report's coverage of the 1977-9 triennium, which typifies how the Society failed to reconcile its traditional equitable assurance obligations with marketing considerations aimed at securing the final transfer of as much former FSSU business as possible. Hence:
"Bonus policy remained central to achieving the Society's marketing objectives. In January 1977 Sherlock commented on the relationship between the two factors. At the same time, he acknowledged the Board's unease that the plan of action recommended on 22 September 1976 did not itself contain the means of closing the gap between earnings and distribution completely. (This was the clearest documentary evidence of the Board's unease at the distribution policies that had been pursued during the previous triennium.) He recommended investment policies aimed at increasing the revenue yield on the fund.

On 25 October 1978, Ranson submitted a paper on the treatment of unrealised capital appreciation. He rehearsed the three call system and illustrated how it might apply at the 1979 valuation. The returns from fixed interest securities were taken as a yardstick for declared bonus. He stated that the method had not been applied at the 1976 valuation because, due to marked conditions then current, no appreciation was available. Market values had recovered and there would be appreciation to bring into account at the 1979 valuation. On the projected values illustrated, he expected that the system could be applied at the declaration. *It emerged that he had departed from benchmarking against current market interest rates in adopting the reference rate for interim bonus in order to avoid a sharply higher level of declared bonus for the triennium and might have led to a reduction three years later. Despite the principled approach rehearsed in the report, pragmatism had prevailed over principle.*

*The expectations of the market were a material factor. It is significant, in the light of what was to happen, that he said that the withdrawal of terminal bonus would be incompatible with the expectations of policyholders based on the Society's statements of practice, and on the assumptions of smoothing* (This is an illustration of what was to become an increasingly cynical manipulation of the concept of Policyholder's Reasonable Expectations in support of a continuing increase in unprotected terminal bonus at the expense of protected declared bonus, which represents continuing bad faith. MN). *A further significant factor was the emphasis on setting bonuses at "desired" levels. It was a further indication of the Society's practice of setting bonus levels to meet objectives rather than allowing them to emerge from the calculated surplus. Interim rates in respect of pensions business were increased for 1979. This was the area in which marketing was concentrated, and the increase improved the Society's competitive position.*

On 20 December 1978, the Board approved interim bonus rates for 1979 on the basis of reports by Sherlock and Ranson. Ranson said that the investment experience of the fund and the differential impact of tax on the various elements of it had resulted in the untaxed fund earning more than was paid to policyholders of that class. Their interim rates should be increased. The taxed fund continued to "pre-empt some capital appreciation", but the untaxed fund required no support from capital. Sherlock agreed with Ranson. His comments were:

"It is evident that pension policies which become payable before 31.12.79 will have received an inadequate share of revenue surplus (and no share of capital appreciation) unless a change is made.

It will become evident to the actuary to the USS once he is instructed during 1979 to consider the future of former FSSU (Federated Superannuation Scheme for

Universities) policies issued by the Society that they are not receiving their fair share of surplus and that would make the case for their long term maintenance difficult.

It seems undesirable to include in our pension policy illustrations bonus rates which might put us at a disadvantage against the market when, as at present, they do not properly reflect the earning capacity of those policies."

*A reason had been found to increase rates for the class of business that the Society wanted to develop. The bonus rates were based on "general" considerations, backed by the office model of assumptions, i.e. the bonus levels had been set at "desired" levels and tested against the model* (P3.43-7, all my italics).

By putting the cart before the horse in this manner, it was possible to manipulate increases in un-guaranteed terminal bonus at the expense of guaranteed bonus. In 3.48 Lord Penrose explains: " The three-call system had become a framework for illustrating the implications of applying different interest rates. The higher the interest rate assumed, the greater the second call, and the greater the ratio of the second to the first call. At the highest rate the second call more than exhausted the capital appreciation available and left the third call negative. Only at the lowest rate assumed was there sufficient capital appreciation to cover terminal bonus at current rates. *The third call was the reserve for terminal bonus, and maintaining it was an independent policy objective. The system was used to support the analysis of results using an arbitrary range of reference rates rather than actual guilt market rates. The critical reference point had ceased to be the objective market interest rate and had become instead a subjective factor selected to produce the desired spread of bonuses (*my italics). The second call represented a substantial reserve for future reversionary bonuses, but on the projection was well within the capacity of the Society." This does not match the writer's criteria for professional and ethical competence, let alone *bona fides.*

*Bona fides* or not, it all had the desired effect. As Lord Penrose says in 3.41: "1979 was "the end of an era" due to the loss of FSSU business. President Murison reported that a far higher proportion of university teachers had transferred to the new self-administered pension scheme than had been anticipated. However:

> "At the same time the planned expansion of the Society has taken place but with greater results than were, or indeed could have been, foreseen. The marketing organisation is, as planned, roughly twice the size it was five years ago, giving better geographic coverage of the country and therefore better personal service to our policyholders. Both in the marketing organisation and throughout the Society, much attention has been paid to training so that business growth has been matched with high quality advice, service, and administration. As a result of a more positive marketing approach, the Society is better known than it was and is used very much more by professional advisers.
>
> The Society has emerged from the last decade well poised for the challenges and opportunities of the next."

Nothing could have been much further from the truth. A road to hell had been paved, and not with good intentions. Fraud and widespread misery were the eventual outcome. And with regard to the underlying objective of retaining as much FSSU business as possible, it should here be recalled that the Finance Act 1978 had introduced the open market option, whereby funds could be transferred to other annuity providers at maturity. The Society therefore had an interest in presenting its fund transfer values in the best possible light under the new regulations. How it did so is described in P14.31-9, and is of more than passing interest because it set the scene of expectation up to the time that the DTBP was privately formulated.

12. 1982/3 marked a further significant turning point in the Society's affairs, viz:

a. The Insurance Companies Act made for more stringent solvency and reporting requirements, from and including 1982 (P chap 3.82).
b. All capital appreciation, whether past or current year's, was now put on the books to support solvency (P chap 3.81. See also Tables A.1-4 for history of allocation of "Appreciations in value of investments treated as surplus")
c. Barry Sherlock stood down, and his deputy Roy Ranson became the Appointed Actuary. However, Sherlock remained the Society's General Manager and Actuary until June 30th 1991(P Appendix A p 749).
d. Ranson proposed abolition of the second call in Nov 1983. "The reasoning for this is obscure (P chap 3.94)"
e. At this time, Lord Penrose also observed (P chap 3.91) that: "There had been a further significant stage in the development of bonus structures. It is necessary to note that the crude level of terminal bonus, before any smoothing, was now related more or less directly to the investment reserve" (P chap 3.91). The Society's long history of a separate estate was effectively at an end.
f. Hence Ranson was later able to say that he did not inherit an estate on becoming Appointed Actuary. Even so, Sherlock and he had been party to the disposal of that estate over the period 1972-83.
g. The absence of an estate, with terminal bonus now taking up virtually the whole of the remaining unconsolidated investments, may have been instrumental in an executive management decision put in place a fall-back differential terminal bonus policy (DTBP), in case GAR option holders later came to be "in the money" (P chap 2.60-65). This fallback DTBP was not communicated to the Board of Directors, and there is still room for doubt as to whether Sherlock knew of it. It is arguable that concealment of the DTBP, in the particular context of the underlying fund structure and financial weaknesses which made it necessary, was the fateful first step in a subsequent descent into fraud. It was certainly a branch on the growing seedling of bad faith.
h. Consistently with this, 1982/3 was also when the sophistries later elaborated in the "With Profits Without Mystery" (WPWM) manifesto began. Sherlock, in his role as General Manager and Actuary, would almost certainly have read and sanctioned, if not reviewed and approved, the resulting paper of the same name, which was first delivered in March 1989 to the Institute of Actuaries. At any rate it was his responsibility accurately to represent the new paradigm the paper described in his 1989 report to the membership. With hindsight we may doubt that he and President Roland Smith did this well enough. For this P14.68-83 is essential reading.

13. Lord Penrose summarises the history thus far as follows: " …Until 1972, the Society had a conservative and relatively unsophisticated approach to bonus, concentrated on reversionary bonuses. Capital appreciation was used sparingly: not more than one-tenth of the appreciation at any time was considered available for distribution.

    Terminal bonus was introduced in 1973 as a marginal adjustment of total allocations at maturity. The three-call system of reserving provided a rational basis for the appropriation of capital appreciation. The system was conservative, making full and prudent provision for future reversionary bonuses during the projected period of deficiency of actual investment returns as against the benchmark yield on gilts. *The terminal bonus "fund" was the balance of capital appreciation, initially off balance sheet, but in and after 1982 shown in the investment reserve* (my italics). Allocation of the investment reserve to terminal bonus was made on a three year rolling average (P4.33-34)".
14. The extra margin of regulatory solvency the1982/3 manoeuvres produced was now also distributed. Lord Penrose duly observes later on: "By this stage, the Society had eroded the "strength" (my quotation marks) of the 1982 balance sheet by progressively cutting back on the reserve for future reversionary bonus until it was eliminated, they had used the previously un-attributed accounting adjustment from 1982 of £4 million, and finally had explicitly, at least in 1987, made a bonus allocation in excess of available returns"(P3.154). As the PR and the various Burgess

Hodgson papers on the EMAG website (www.emag.org.uk) make plain, this situation continued for most of the Society's remaining life.

15. This involved treading a narrow path very carefully, which was facilitated by keeping accounts related not just to two approaches to asset and liability valuation as mentioned in EARW, but three, namely Companies Act accounts, regulatory returns, and internally for management purposes, its "office" valuation. Lord Penrose adds: "Subject to the discussion that follows, the office valuation approximates to a realistic presentation of the Society's actual financial position" (P 6.2). The implications of this are far-reaching.
16. The next turning point arose in anticipation of the new personal pension and cessation of GAO policies. Lord Penrose relates: " On 24th June 1987 the actuary presented a paper on the new personal pension then expected to be introduced from 4 January 1988. *The paper did not identify features of existing business that would be departed from* (my italics). It stated, however:

> "A strategy document was formulated by the end of March and agreed by the senior management team. A major component of the strategy was to make use of existing products, as much as possible, in order to minimise the changes needed to existing administrative and computer systems, and to enable the Society to exhibit an unbroken track record of past performance"

The new form of business was to be presented as aligned with the superseded retirement annuity contract to ensure that previous performance records could be used with reference to the new contract. *In management records it was noted that premium bases would be the same as for retirement annuity basis. In the present context the decision was reflected in distribution practice going forward*.

*In relation to bonus policy, this was a momentous, and ultimately disastrous, decision. Had the Society acknowledged liability to meet the annuity guarantees, it would necessarily have identified a difference in the benefits provided by the former and the new contract forms. For equal premiums, the new personal pensions offered lower levels of contractual benefits. On conventional actuarial practice the Board might have concluded that a higher level of bonus was appropriate for the new business accordingly* (or, as was observed during the actuarial discussion of the WPWM paper, explaining the significance of the guarantees and charging for them appropriately-MN). *The means of calculating the difference were available in the developing techniques of stochastic modelling. The Society might have avoided the Hyman problem at the outset.*

*There would undoubtedly have been marketing implications. Policyholders might have preferred to switch to the new forms, the marketing push of 1987 and 1988 could have been abortive. The Board might have been forced to propose a new with-profits fund, closing the old fund to new business. But adopting a market-driven policy, against the background of the management decision in 1982-3 to "solve" any emerging problem by discriminating at maturity (i.e. the DTBP- MN), established the bonus policies and practices that were thereafter to develop, and to lead to the confrontation of 1997* (all my italics: P 3.138-40).

Lord Penrose did not add that, however uncomfortable it may have been, there was by any reasonable standard an **absolute requirement** for the executive directors on the "senior management team" to disclose the existence of the covert DTBP to the full Board at this fateful stage, and indeed to minute the ensuing debate. But had they done so, it may safely be asserted that any reasonably competent non-executive director never should, could or would have contemplated the inequities and risk that, together with loss of the estate and persistent over-allocation, thereby transferred to the new fund and its future policyholders. From this point on, if not since 1982-3, the Society was trading on a false and fraudulent basis; one that went on to enmire a further 930,000 new non-GAR members. The magnitude and duration of the resulting fraud is truly astonishing, and the burden of responsibility carried by the "senior management team" is correspondingly heavy. One naturally wonders who the instrumental members of that team were over the period 1982-8, and looks forward to

the Serious Fraud Office bestirring itself to tell us. Not surprisingly, a number of non-executive directors since 1987 have pleaded their ignorance. Under the circumstances there is a continuing and serious injustice in the authorities leaving their fate to the whim of the adversarial process without having helped to clarify the background. On this subject Lord Penrose concluded: *"…It appears unlikely that most members of the Board knew of the differential terminal bonus policy or its implications until the autumn of 1998, or that those who knew anything of the policy understood that it could have serious implications for the Society"* (P2.112; my italics).

17. The next important development came in 1988-9, and was marked by the delivery and publication of the WPWM paper, the origins of which (as the paper itself says) were heralded by the changes in 1982-3. Lord Penrose discusses it in P4.1-11 and 4.24-6. A more detailed criticism of it has been given in EARW Sections 3 & 4 plus Appendix I, which has been summarised above. However, it must now be re-appraised in the light of knowledge that the Society was over-allocated when it appeared, and that the senior management team already had the undeclared DTBP in place. Furthermore, at least three presumed members of that team (Ranson, Headdon and Driscoll) had devised the WPWM paradigm. It is sufficient to add that sophistries based upon a premise which is secretly liable to renegation are fraudulent. Consider again whether P14.68-83 represented this correctly. The sapling of fraud had sprouted new leaves, and each WPWM sophistry in time grew to become a branch on a mighty tree.

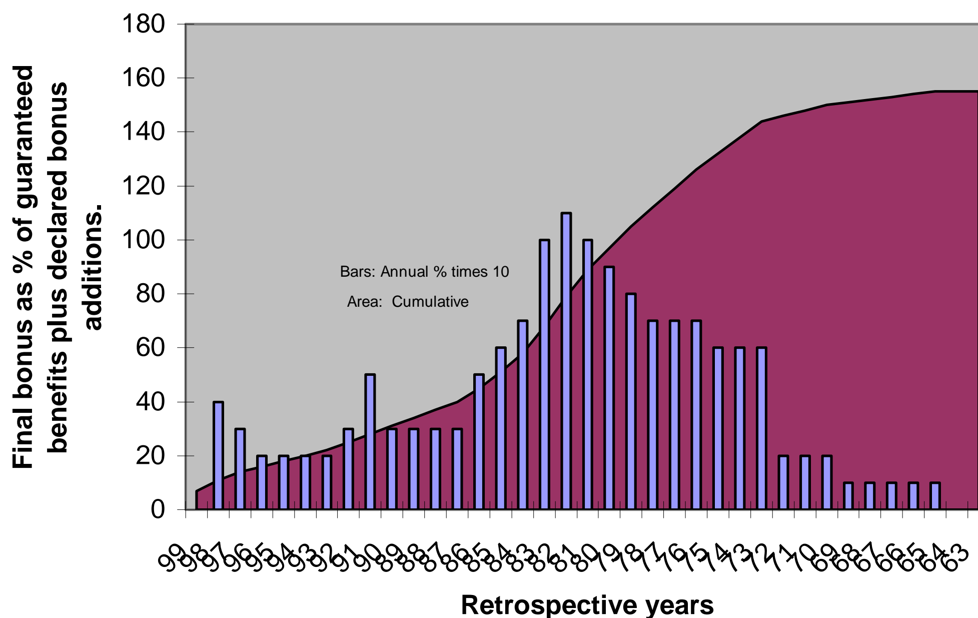
**So who gained the estate, plus further over-distribution at later policyholders' expense?**

18. Besides saying how the money may have disappeared, Lord Penrose has also indicated where and when it did so. Professor Smith's presidential statement in the 1992 accounts includes: "… The fundamental philosophy is that each generation of policies should receive benefits commensurate with the earnings produced during its lifetime. Beyond the bounds of normal commercial prudence, it would be alien to our culture to hold back benefits from one generation to build reserves for a future generation. As we say in our literature, for new policyholders future bonuses must depend primarily upon the earnings produced on the investments of the new premiums. Any deliberate cross subsidies between generations would not be "equitable". Lord Penrose comments*: "As appears frequently in these documents, there was an inherent contradiction in the statement. If nothing was held back for the future, any over-allocation had to be recovered from the future. That had to involve deliberate anticipatory cross-generational subsidy and to be, in these terms, 'inequitable'"* (P chap 4.82-3, my italics; see also EARW p7). Did Professor Smith know this?
19. A more detailed account of cross-generational subsidy is given in chap 6.71-3. Lord Penrose explains: "…While the split between GIR, reversionary bonus and final bonus might vary depending on the policy structure, the same total return was credited to accumulated policy values regardless of duration. This contrasted with the practices of many other companies with significant amounts of single premium business, where more flexible bonus systems allowed for variation according to duration in-force and financial experience over the relative periods. This flexibility allowed inter-generational smoothing and enabled the company to avoid locking in to payout patterns in the way the Society did" (¶ 71). And: *"More generally, it is unclear on what basis the Society could ever have expected to have been able to operate without inter-generational transfers in the absence of flexibility to differentiate by duration. In With Profits Without Mystery it was acknowledged that each generation of maturing policies was dependent on capital provided by succeeding generations. Flexibility to differentiate by duration would have been necessary for such a system to operate fairly in the absence of an inherited estate. The Society's practice did not provide that flexibility, and, given its full distribution policy, over-payment on older duration policies was the direct result" (*¶ 73). This, then, was a crucial piece of knowledge for better-informed policyholders or groups if they wished fully to exploit product flexibility, and the availability of total policy values from 1987 onwards. It also

seems fair to assume that few individual members without access to well-connected financial advice would have known this.

20. With this explanation in mind it is also instructive to look at PR Table 6.13, which shows the effect of accumulation in policy value alone or as a percentage of asset share, and of the different categories of bonus within policy value. It covers the years 1980 to 2000, and it illustrates how terminal bonus becomes the dominant element over time. Table 6.16 is a similar breakdown, but based on asset share per £1000 invested annually over the same period, and it paints a broadly similar picture. Unfortunately however, these tables do not go back far enough to cover the whole of the critical period spanning dispersal of the Society's estate. Interestingly, however, there is a table of terminal bonus accumulation over the 35 years preceding 1999, albeit expressed as a percentage of all the guaranteed elements. It forms part of Society leaflet (45J099 WP/UL 2.99) entitled: "Pension and Life Assurance Plans. Annual Statements- Further Information". When plotted as in the figure below, the data show that the biggest relative annual terminal bonus additions were made over the 1973-86 period, i.e. that spanning the dispersal of the estate during which Barry Sherlock was the Appointed Actuary and subsequently Managing Director. This was also the period of steepest relative accumulation rate of terminal bonus. The graphs also indicate how much terminal bonus was awarded retrospectively to policies in force during the decade prior to its introduction in 1973.

**Growth of final bonus working backwards from the 1999 policy anniversary.**




NB: The cumulation profile illustrated is **relative** to the guaranteed elements of individual asset share and guaranteed bonus cumulation (the cumulation of which is also important for determining the **absolute** amount of asset share, which in turn depends upon individual contribution history). It assumes a constant level of annual contribution, but, given the structure of the fund, suitably informed policyholders might have done well to increase their later contributions, which they could do up to a maximum tax allowance limit. They would also then have had to crystallise their gains at an appropriate and advantageous time; later policyholders whose policies had more time to run were perforce left exposed, and had also to meet the costs of previous over-distributions. After 1985/6 the real glory days of terminal bonus and potentially crystallisable gain were over. <u>From the sales point of view it all looked very impressive, and so it is not surprising that the senior management team wished to carry these figures over to support an extended fund in 1987. The prospect of such performance continuing on the same basis was,</u>

however, entirely without foundation, such that the use of these prior performance figures was inappropriate, un-representative, and misleading.

21. The beneficiaries of "deliberate anticipatory cross-generational subsidy", who received the rump of the estate and more between 1973 and 1987, were thus longer duration policyholders who were selectively favoured (P3.46, 51, 60, 74, 94, 103, 109, 112, 129, 144, 145 items 5 & 8, 152, 161 & 168; P4.16 &36; 14.68). And since the GAR option was withdrawn for policies begun after 1988, this group was also essentially comprised of longer-term GAR policyholders. Moreover after 1987, "The advertisement of "policy value" to members who had reached an age at which it was open to them to take their benefits allowed those with the financial acumen or appropriate advice to elect for an early maturity date and crystallise their benefit entitlement at an unduly high value to the disadvantage of continuing members. In the early 1990's, this was facilitated by new flexible products developed by the Society" (P4.29). The implications of this are serious, and the more so if they involved fund switching.
22. One reason for the selective bonus allocation to policies of particular durations was said to be maintenance of the Society's position in performance tables, i.e. marketing considerations. But, as explained in EARW Section 3 p9 et seq., the historical problem was that established members would resist significant increases in membership because it diluted their own claims on the estate. Given the Society's commitment to expansion and to retain FSSU members, it would have been politic to forestall this by awarding longer term members a disproportionate share of the estate. One must also hope that similar favours were neither sought nor proffered for inward transfers of longer duration policies during the drive for expansion.
23. Lord Penrose summarises some of this as follows: "In 1986 and 1987, the sums available in investment reserve were supplemented by the appropriation of general reserves amounting to £4m to massage total payouts on pension business at sensitive durations, taking the Society into a position of over-distribution by the end of 1987 at the latest. Adverse market conditions aggravated the position, and an excess of aggregate policy values over available assets continued into 1988. In 1989, when there was a good return, the Society deliberately distributed a high proportion of the available return for market-related reasons, and accordingly entered the 1990's with a negative estate (P4.36)". But, as revealed by the above account and graph, this is unlikely to be the whole story.
24. Depending upon personal and external circumstances, postponement of retirement could also achieve the same end. Consider, for example, Headdon's explanation of why the actual results for 1995 had shown payments to policyholders considerably in excess of those projected for the year. " It appears that some clients were delaying retirement until the managed pension contract became available. A substantial part of retirement proceeds will, in fact, have been left with the Society and contributed to the premium income position…". In the same paragraph (P4.128) Lord Penrose himself continues: "The consequences of the managed pension for policyholders was to become a significant factor in the closing years of the reference period. Evidence from the independent financial adviser sector indicates that some at least some of its practitioners appreciated that it was to the advantage of their clients to take benefits at a time when policy values were high relative to underlying assets."
25. These inequities were complicated by the fact that group pension scheme trustees were able to delay the withdrawal of GAR policies in 1998," insisting on the right to introduce new members to their schemes for a further five years" (P2.43-4). This would also have made the introduction of the DTBP a very sensitive issue until the five grace years were up, which is highly likely to explain why it did not surface until 1993, even though the need for action of some sort was increasingly urgent. If so, it also had the effect of extending the period during which GAR crystallisable gains could be made with impunity. For a discussion of the significance of this and related matters see the "Fat Cats and Poor Mice" section of the Level 2 narrative.
26. Assuming that they were members of the Society's pension funds, we may follow the combined effects of all this on the pension fund contributions of Sherlock, Ranson, & Headdon. The PR does not say when Sherlock joined the Society, but that he retired in 1991. He would have been a contributor for several years before Ogborn retired,

and so would have got all the retrospective terminal bonus additions as shown in the figure. He would also have crystallised his gains at full value with all his fund choice options intact. Ranson, who joined the Equitable in 1951, would likewise have accumulated the same terminal bonus as Sherlock. He retired in 1997 after the DTBP had been announced and implemented, and so assuming he stayed in the w-p fund he would have had to take the hit if he exercised the GAR option. However, his GAR in possession would have been at a low rate, such that he might not have considered himself sufficiently "in the money". Under the prevailing circumstances and given his expertise, he may not have elected to remain in the w-p fund. Headdon joined in or around 1978. The figure indicates that his terminal bonus accumulation would have been approximately 2/3 that of Sherlock and Ranson. However, he would have had a higher GAR in possession. Even so, at the time of his forced resignation on March 1st 2001 he would have been most unwise to take his benefits from the w-p fund. Nash's situation would presumably have been closer to Headdon's than Ranson's- he resigned on Dec 8th 2000.

**No estate + no un-hypothecated reserves = no smoothing policy…**

27. Accordingly, despite looking, Lord Penrose has found no evidence that any defined smoothing policy ever existed under the WPWM concept. He summarises: "There was at no time a statement of the Society's smoothing policy. There was no specification of smoothing parameters, as regards a target line of equilibrium, deviation above or below any such line, target durations of any smoothing cycle or any other factor. The description of the position in the late 1980s as a point on the smoothing cycle appears to have had no basis in reality. It would have been possible to consider the restoration of reserves between 1976 and 1982 as part of a smoothing process if the parameters had been defined. From 1982 until the end of the decade the Society had progressively weakened its reserves until a negative position had become established where policy values intimated in illustrations and on payout exceeded available assets. If there had been a smoothing cycle, it was without defined limits of value, and it was without defined limits of time" (P3.169. See also P6.22 & 12.121-3.)

**…so how did the Society maintain the semblance of one under circumstances of chronic over-allocation exacerbated by debt?**

28. What passed for a smoothing policy was expressed rather differently, and to understand it one must first make a distinction between the mechanisms the Society used to meet the guaranteed and non-guaranteed portions of maturing claims. In Lord Penrose's words: "Terminal bonus payouts were made out of current year surplus with the remainder of the actuarially determined surplus being made available for declared bonus or carried forward. Consequently the value of a claim would represent a policy's aggregate policy value with the guaranteed portion being met by a reduction in the Society's liabilities and the non-guaranteed (terminal bonus) portion being met by a reduction in current year surplus. This method was adopted in both the accounts and the return.
*The Society's ability to account for terminal bonus in this manner circumvented recognition in any form in either the statutory accounts or the regulatory return of the balance of the accumulated terminal bonus accrued on in-force business and intimated to policyholders* (my italics; cf. EARW Section 4: Sophistries of the Second Order Item 3). Whether or not the Society was under any obligation to account for the accrued value of such terminal bonus allotments (which gave rise to an off balance sheet exposure) in either its accounts or returns depends on meaning and effect of the various reporting requirements discussed earlier" (P10.78-9). Bluntly, the guaranteed element was booked for without the backing of a free asset or mismatching reserve, while the floating terminal bonus element was both taken off the books and "ponzified", i.e. allowed to be the first call on the Society's annual income as policies successively matured in an uncontrolled, albeit not entirely

unpredictable fashion. Ponzification of the un-guaranteed element thus became the mainstay of short term "smoothing"

Thus informed we can address P12.121-3, which state: "Ernst & Young sent a monthly insurance letter to the Society. In October 1995 the letter was entitled "Creeping Insolvency". It raised a number of points. *It suggested that non-executive directors of life offices might want to consider the following issues* (my italics):

i. Not all the surplus represented by the difference between assets and liabilities would be available as "free capital".
ii. Part of this surplus would need to meet the cost of terminal bonuses, and the amount would be determined using assets share techniques.
iii. It was, of course, true that until the terminal bonuses were paid, the relevant funds were available for investment, including investment in new business (i.e. the so-called "investment reserve" mentioned in the WPWM paper- MN), but care needed to be taken in matching cash flows, taking into account the maturity profile of the with-profits portfolios.
iv. The non-executive director might therefore ask the Appointed Actuary to demonstrate the level of free capital after allowing for terminal bonuses and additional capital required to smooth bonuses.
v. It was quite possible that the resulting free capital could be negative, which would indicate an urgent need to reduce bonus rates and move to a lower risk investment strategy.

Headdon responded to Ernst & Young stating:
"I was very interested in the above newsflash on questions a non-executive director of a life office might ask the Appointed Actuary. There was, however, one point, which caused me some concern. That was the suggestion on page 3 that, if the free capital after allowing for terminal bonus is negative, that indicates an "urgent need to reduce bonus rates and move to a lower risk investment strategy".
*If one considers a with-profits mutual which operates on the "revolving fund" principle with no estate and which aims for a "full distribution" policy, then, on average, policy values should be above underlying asset values half the time. (They would, of course, be below for the other half of the time.) For such an office that is what smoothing would mean"* (my italics: see also EARW Section 3: Sophistries of the First Order Items 3-7). Headdon's "smoothing" was thus maintenance of total policy value by means other than more formal reserving, and not by easing any fluctuations in the annual overall rate of return.

Bannon (E & Y's audit actuary John Bannon- MN) replied on 8th November saying,

"I agree entirely with the point you make regarding free capital in the context of a revolving fund principle with no estate". He agreed that the sentence quoted by Headdon should therefore be qualified. He added, "I have to say I am very much in favour of the "full distribution" policy, but when I wrote the article I had more in mind those offices which maintain a cushion of free assets to facilitate smoothing."

It is not clear from his reply that Bannon had fully appreciated what Headdon was saying, and which did not tally exactly with Sherlock's account of smoothing in his February 1989 letter to RAP policyholders (P14.71). Sherlock wrote:" …the benefits under our with-profits policies depend primarily on the successful investment of the premiums and only marginally on profit arising from other policies. Further, we aim to ensure that the total proceeds members receive reflect the investment returns on the fund during the course of the policy. *However, the essential nature of with-profits business, namely the steady addition of declared and, therefore, guaranteed bonuses, means that there is no automatic link between asset values and policy benefits* (which with hindsight resembles Ponzi by another name-my italics). In simple terms there is a smoothing of asset values over time and of the peaks and troughs through the bonus system. Although the with-profits system contains within it an essential element of smoothing, nevertheless the Society's practice is to limit that to evening out peaks and troughs and unduly sharp changes from year to year. Specifically, we do not set out to build up excessive "free reserves", which some

describe as "strength". This could only be done by deliberately, or worse still, accidentally, withholding part of the return due to members for the benefit of their successors. What is important is that there should be sufficient strength to avoid any unplanned constraints on investment freedom or growth in business (if only it had been so- MN), while still giving "full value" return to existing members." Policyholders would not have welcomed the idea that policy values were subject to fluctuation from year to year, and would have understood smoothing in its more normal sense of operating on the annual rate of return only, and not policy values as well. And since Lord Penrose stated earlier in the same paragraph that the hidden DTBP was not mentioned, policyholders would not have known what else was implicit in the above italicised sentence. Once again the rest of P 14.68-83 is useful background information, and cf.16-17 above.

These extracts are of particular interest because they bring so many critical aspects of the story together, and illustrate why their combination had such far-reaching effects. They also give an inkling of John Bannon's expectations as to the degree of working knowledge that non-executive directors should have had, but which had not been provided at the Equitable. One is also bound move beyond Lord Penrose's exposition and ask what hope there could have been for keeping policy values above underlying asset value even half the time once more debt had been taken on to extend the original over-allocation. Next, factor in the belatedly and obscurely disclosed DTBP, and attempt to reconcile it with the "ponzification procedure" in a climate of good faith: at which point the edifice finally collapses. In essence, this is the sophisticated position that eluded directors, E & Y, the F & IA and the regulators. We should not too readily assume, however, that individual actuaries and auditors in various branches of their professions had not suspected or deduced the essence of what was afoot.

**Valuation and hypothecation considerations.**

29. With the understandings of the previous section behind us, we may usefully consider the potential ambiguities in hypothecation and valuation methods, of which the Society took over-liberal advantage during the period we have been considering. In P13.36 Lord Penrose quotes Ronald Skerman as follows: "If solvency were understood to mean no more than the fulfilment of contractual obligations, it would be appropriate to use a gross-premium method of valuation (i.e. one under which the net liability is the value of the sums assured, and any existing reversionary bonuses, less the value of the office premiums actually payable reduced by an appropriate allowance for future expenses). It is not considered, however, that this would be satisfactory in relation to with-profit policies. *Under with-profit policies policyholders pay premiums greater, and sometimes materially greater, than are required to provide the sums assured on death or maturity. If credit is taken in the valuation for these premiums less an appropriate allowance for expenses, this would mean that amounts included in premiums payable in the future which ought to be available to provide future profits would be capitalized so as to reduce the amount of the liabilities, and that for some years after issue the net liability under a policy would be negative. Thus, an office would be able to fulfil a solvency test using the gross-premium method of valuation, even though it had spend the amounts included in premiums payable in the future which the policyholders would expect to be used to provide future profits. Such an office would not, however, be in a position to fulfil the reasonable expectations of its with-profits policyholders because it would have little or no prospect of providing profits to them in the future.*

    *Under the net-premium method of valuation, the premiums valued exclude any amounts included in with-profit office premiums which would provide profits to policyholders. Thus, these amounts receivable in the future are not capitalized so as to reduce the amount of the liabilities and, if solvency is demonstrated using a net-premium method, then, broadly speaking, the amounts included in future premiums which should provide profits for policyholders will, in fact, emerge as surplus from*

*year to year in the future and be available for this purpose. The use of the net-premium method leads to the thought that in relation to with-profit policies the suggested standard dose a good deal more than achieve solvency in terms of ensuring the fulfilment of contractual liabilities. It might better be regarded as a standard of good conduct so far as with-profits contracts are concerned* (my italics).*"*

30. With Skerman's thoughts in mind, we move next to pages 2 & 3 of Appendix 3 to the Corley Report:

    7. "The Equitable reported to its members through its Companies Act Accounts (the "Accounts") and also through returns to the FSA (the "Returns"). These FSA Returns have the specific objective of demonstrating that the excess of assets over liabilities, both conservatively assessed, exceeds a minimum level of capital specified by European legislation.

    8. The standard approach by most UK long term insurers is for the long term provisions in the Accounts and the equivalent provisions in the FSA Returns to be identical. However this is not prescribed, provided that the provisions are calculated in accordance with the actuarial principles set out in the EU Directive on the solvency of long term insurers.

       The Equitable was exceptional, if not unique, by adopting a "Gross premium" valuation basis in their accounts, and this was the item rationalised in their 2000 accounts as "realistically prudent technical provisions.

    9. A Gross Premium basis establishes as a long term business provision a present value for future cash flows, including an allowance for bonuses payable on with-profit policies. *The Equitable's returns indicated that they made a specific allowance for rates of future reversionary bonus additions at levels consistent with the valuation interest rates used. They indicated that the balance of total policy proceeds would be met by final bonus additions at the time of claim. Such additions were not explicitly reserved for in advance but were implicitly covered by the assets in excess of the provisions. Until 1998, no explicit provision was established for the guarantees as they were regarded as covered by terminal bonus adjustments* (my italics). Paragraphs 3.11 and 3.12 of the Annuity Guarantee Working Party's report (listed in Appendix 9) are of some relevance here. The accountability for such provisions in the Accounts is that of the directors, who would look to a "reporting actuary (as envisaged by Guidance Note 7) for comfort. The reporting actuary is not necessarily the Appointed Actuary.

    10. The returns require a "Net Premium" valuation basis- the "statutory reserve". This generates an ultra prudent assessment of the provision to pay contractual liabilities (but not of the amount needed to satisfy policyholders' reasonable expectations). An additional margin is added through a resilience reserve to provide for the extra liability if certain prescribed adverse deviations from the basic assumptions occur. The Appointed Actuary has to certify the technical provisions and resilience reserves. *Compliance with GN1 and GN8 also has to be certified. GN8 says that the actuary must be satisfied that the long term fund is able to support a proper level of future terminal bonus having regard to the bonus smoothing policy* (always assuming there was a valid smoothing policy- my italics). This support may be available in any excess of the asset value of the fund over the statutory reserve and in prudential margins in the technical reserves.

    11. In the pre-resilience reserve era it is conceivable that a Gross Premium basis might have looked quite strong compared to a typical Net Premium valuation with allowance for deferred acquisition costs, particularly in the financial conditions of the time.

*The existence of margins in the valuation basis, especially pre valuation regulations, enabled a company to provide in an implicit fashion for options.*
*The fact that an explicit provision for an option was not established does not necessarily mean that a liability has not been provided for. We can merely note the existence of margins; we were not able to assess the adequacy of these to cover the additional liability related to options (on any of the three bases outlined in paragraphs 4to 6 above-* my italics*).*

12. Neither the accounting bases nor the solvency reporting bases described above include an explicit allowance for terminal bonus. It follows that, to the extent that GARs could be met by reductions in terminal bonus, the accounting and solvency provisions would not necessarily have to be augmented to cover the cost of the options".

Lord Penrose summarises this situation and the modified Ponzi element in P10.78-9:

*"78. Terminal bonus payouts were made out of current year surplus with the remainder of the actuarially determined distributable surplus being made available for declared bonus or carried forward. Consequently the value of a claim would represent a policy's aggregate policy value with the guaranteed portion being met by a reduction in the Society's liabilities and the non-guaranteed (terminal bonus) portion being met by a reduction in current year surplus. The method was adopted in both the accounts and the return.*

*79. The Society's ability to account for terminal bonus in this manner circumvented recognition in any form in either the statutory accounts or the regulatory return of the balance of the accumulated terminal bonus accrued on in-force business and intimated to policyholders. Whether or not the Society was under any obligation to account for the accrued value of such terminal bonus allotments (which gave rise to and off balance sheet exposure) in either its accounts or returns depends on meaning and effect of the various reporting requirements discussed earlier* (my italics)*."*

One way or another, this state of affairs could only have been contrived and consistently maintained in deliberate and conscious bad faith. In considering this further, please refer to the next section, which deals with PRE, issues of good faith and related duties.

31. It is therefore of interest that Corley was in the Presidential Chair and Skerman was in the audience when Ranson presented WPWM to the Institute of Actuaries in London. Skerman did not comment on the inappropriate use of the gross premium method described in Section 3.1 of that paper, possibly because he expressed approval of the working definition of PRE given in section 4.2.4, which said: "A natural consequence of those views is that "policyholders' expectations" expressed as a relationship of future bonus rates to current levels are also meaningless. *In our view the reasonable expectations of policyholders are that an office will conduct its affairs so as to produce the best return it can in the conditions which prevail, and will distribute those returns fairly between different participating policyholders in a way which smoothes the emergence of the earnings. Such an approach is, of course, very much in tune with that expressed by C.S.S. Lyon in his recent paper. The approach is also useful internally in, say, discussions with directors about maintenance or otherwise of bonus rates. If future bonus rates are clearly seen to depend upon future earnings then it is not difficult to paint the various pictures arising in different investment climates."* It is now clear, however, that the Equitable senior management team had not adhered, did not adhere and would not adhere to this definition, such that Skerman was among the many who were deceived. Nevertheless J. Plymen (WPWM p332-3) was very clear about the virtues of the net premium method, and pointed out that other valuation systems were inequitable, if more competitively attractive over the short term. He concluded that a *"…system of analysing the surplus of a net premium valuation by an adjusted gross premium valuation gives all the answers on the following counts: The size of the estate; the*

*strength of the investment reserves; the effects of rising costs; projected profits for the next three years, using a form of model office; the long term growth rate of profits; for proprietary offices, and evaluation of the share price."* Events were to show that, given their special knowledge and the questions they needed to be answered, both the prudential and conduct of business regulators should have been making similar complementary use of valuation methods. They should also have been alive to the dangers of the gross premium method in the Equitable's peculiar circumstances. In due course the need for complementary valuation methods became more widely recognised, and a similar complementary valuation methods were proposed and debated from 1996 onwards (P13.88-98). Since GAD (government Actuary's Department) actuaries made contributions to this debate and publication record, their failure to follow the position up is the more surprising. And it is also clear that the Society's use of the triple accounting process was antithetical to Ranson's 1988 statement in discussion of Lyon's paper, from which we can only conclude that it was done in deliberate bad faith.

**Policyholders' reasonable expectations (PRE), issues of good faith and related duties.**

32. Having just touched upon valuation and the regulatory returns in relation to PRE we may move on to note that, in discussion following C.S.S. Lyon's paper *The Financial Management of a With-Profit Long Term Fund- Some Questions of Disclosure* in 1988 (EARW section 5, p11), Roy Ranson had said: *"I support the author's suggestion that the, to use his words, "moral charge" which existing terminal bonus has on the free assets might be reported. If the free assets remaining after such an exercise were used as a sign of so-called "strength", such a disclosure would need to be supplemented by a note about the office's approach to with-profits business"* (my italics). But by this time the Equitable was over-allocated, such that Roy Ranson as its Appointed Actuary had no basis for making this important statement, which under the circumstances could only obscure and mislead. The simultaneously emergent reality, which would have been both revealed and supported by the Society's triple accounting process, was very different. Lord Penrose observes: "However, the accelerating growth in terminal bonus payments was fairly consistent over time. And that pattern emerged whatever the current financial experience of the Society (it should have implied the existence of an effective smoothing policy if all was otherwise well- MN). *The reasonable expectations of policyholders at any given time would have been that the pattern would be sustained in the reasonably foreseeable future in the absence of financial catastrophe. Had the Society recognised terminal bonus in its statutory accounts and regulatory returns on any basis consistent with PRE, its financial weakness would have been exposed throughout the 1990s"*(my italics; P chap 14.186).
33. More specifically, while summarising Ranson's role, in chap 19.128 Lord Penrose says: "In relation to the Society's regulatory returns, Ranson did not apply successive regulatory requirements requiring the valuation of

    Guarantees explicit on the face of the with profits pension business; and

    Any options that were from time to time in the money, relative to the Society's primary obligations

    *As a result, the Society's regulatory returns failed to identify and value the growing guaranteed obligations that resulted from a combination of falling interest rates and lightening mortality experience. Such references as were made to these guarantees in and after 1994 (relevant to the 1993 return {i.e. when the DTBP finally emerged after 10 years below stairs- M.N.}) failed properly to disclose their nature and extent to the regulators* (my italics)*."*

34. In chap 19.147 Lord Penrose concludes: "In the case of the Companies Act accounts there was a failure to identify and to quantify in an intelligible way differences arising from changes in assumptions, and a failure to relate the consequences to PRE. In

particular, between 1990 and 1997 (which the writer takes to be for the years 1989-96, i.e. from the official start of WPWM until the end of the GIR period) the Society's published financial statements failed to inform policyholders of the analysis of the movements in value resulting from changes in actuarial assumptions, and failed to draw attention to resulting discrepancies between the policy values intimated to them and the relative liabilities reflected in the accounts". In other words, there was persistent non-disclosure of crucially relevant information to policyholders, let alone risk-carrying mutual society owners who had every right to it.

35. It has previously also been shown that C.S.S. Lyon's "moral charge" was effectively made a real one by Ranson and Headdon's statement in their 1989 paper to the effect that, since the Society's practice was to pay out policy values in full, then the relative proportion of the guaranteed and un-guaranteed elements was of minor importance (R & H section 3.2.6; EARW section 5 p 12). Of this Lord Penrose says: *"…That representation was consistent only with a bona fide intention to pay a final bonus according to current market conditions and the stage in the Society's smoothing cycle, if there were a relevant smoothing policy…"* (P chap 19.78; my italics). And yet in discussion of the Edinburgh reading of the paper in 1990 Ranson had belied this statement by saying: *"…In practice, we also pay full value on withdrawal and surrender at any time. That is not guaranteed and that could be the first thing to go if things got difficult…"* (EARW p 9; my italics). But at the same time "Ranson did not advise the Board of the risk that persistent practice associated with published statements of practice would develop policyholders' reasonable expectations (PRE) that existing patterns of payment would continue to characterise the Society's bonus practice in the future. In particular the advice that future terminal bonus payments were not guaranteed (that is not contractually due) diverted attention from the risks associated with the generation of non-contractual expectations of future bonus payments" (P chap 19.121.) Where, then, was the good faith? And how is all this to be reconciled with the prior covert existence of the DTBP?
36. The expression "policyholders' reasonable expectations" (PRE) first appeared in Ronald Skerman's paper *A solvency standard for Life Assurance Business*, published in 1966. His reference to PRE came in his discussion of the essential characteristics of with-profits business and of his five principles of valuation (P13.34).
37. Skerman's paper identified three problems, of which the third was: "Participation in profits. Holders of with-profit policies have taken them out in the expectation that they will benefit from a share in profits from time to time. Although an office is not under a contractual obligation which can be quantified in relation to the benefits which its policyholders will derive from future profits, it would be unsatisfactory not to take some account of the policyholders' reasonable expectations when determining the value of the liabilities." Lord Penrose says*: "Skerman identified the expectation that concerned him: the expectation of benefit from profits arising from time to time. He thought that the valuing actuary should have regard to the reasonable expectations as to participation in future profits in selecting the method used in determining the value of liabilities. His five principles were elaborated against that background* (P13.35; my italics)".
38. Having in ¶ 36 quoted Skerman's exposition of his first principle in a most informative discussion of the gross and net premium valuation methods, (which is given in relation to hypothecation in the preceding section,) in ¶ 37 Lord Penrose observes: "Skerman was not concerned with the content or meaning of the expression "policyholders' reasonable expectations". He was concerned that the actuary should have regard to the reasonable expectations as to participation in future profits in determining the value of the liabilities. *That required the adoption of a valuation method that avoided setting off against current liabilities that part of the future flow of premium income that was not related to guaranteed benefits, so leaving surplus generated by that part to emerge over the duration of the contract and to create the bonuses that policyholders reasonably expected to emerge in parallel with it*"(my italics). But, at the Equitable that surplus, plus the prior estate and a charge raised against the future had been "deliberately" distributed elsewhere.
39. "The prospect of failure to meet the "reasonable expectations" of policyholders and potential policyholders was introduced as a trigger for regulatory action in the Insurance Companies Act of 1973 sections 12(1) and 21. The expression was not

defined by Parliament" (P chap13.9). "The provisions as finally enacted in 1973 were consolidated in the Insurance Companies Act 1982, sections 37(2)(a) and 45(1)(a)" (P13.40).

40. All five versions of the Faculty and Institute of Actuaries Guide Note 1 (GN1) issued over the period 1/05/75 to 1/09/96 make reference to the above provision in the 1973 and 1982 Acts, and the resulting duties of appointed actuaries in regard to them. This included advising their companies on relevant contributory factors, and from version 2 onwards their own interpretations of policyholders' reasonable expectations (P13.57-94).
41. Furthermore, "…It may be appropriate to note that paragraph 2.3 of GN8, from 1994 onwards, mentions that the appointed actuary would be expected to make investigations in order to be satisfied that the long-term fund was able to support a proper level of future terminal bonus having regard to the bonus smoothing policy followed by the office…"(P6.111. See also EARW section 5 p 11).
42. With this summary of PRE in mind, it is relevant that:
    *a.* With regard to the Society, the earliest comprehensive written presentation on PRE was made to the Equitable Board by Headdon on 26th Nov 1997, i.e. not until both Sherlock and Ranson had retired (P14.1). Lord Penrose comments (¶ 3): "The broad statement in paragraph 8 stated that PRE was a function of the policyholders' response to what was communicated by the office about the management of the business is incomplete. But, even on that basis, distribution policy would be an aspect of PRE, but not the measure of it. Further, as appreciated by the departmental officials in discussing PRE, the regulator may become aware of facts and circumstances that had not been communicated to policyholders in any way, but that might threaten the office's ability to meet reasonable expectations. *In his analysis Headdon gave inadequate weight to the conduct, as distinct from the comments, of the Society as a factor contributing to PRE* (my italics). But the statement provides a valuable insight into the understanding of the Society's staff of the requirements derived from policyholders' reasonable expectations, both generally, and in relation to participation in surpluses. *It was also an explicit acknowledgement of the appointed actuary's responsibility that had no real precedent in the Society's practice*" (my italics). As to why the presentation may have been made to the Board, Lord Penrose says in ¶ 4: "This report was presented a few months after Headdon had advised Nash of his analysis of the Society's past over-distribution and of his view that it would take some fifteen years to achieve equilibrium. *That analysis of actual experience was not reflected in the advice"* (my italics). For an analysis of the Nash memorandum see P6.47-53.
    b. When it comes to the specific issue of the GAR, it is sufficient to quote from Lord Penrose's analysis of the Society's communications on PRE and bonus "But, given the Society's advertised commitment to openness of communication, there was no basis for a reasonable expectation that the Society had created a potential conflict between guarantee annuity policyholders and other with-profits policyholders (P14.13)" – and*: "But so far as the new personal pension policyholders are concerned the search by the inquiry for an indication that there might be an adverse impact on policy proceeds arising from competition between classes has been in vain"* (P14.69; my italics). This is also, of course, an inherent characteristic of general mis-selling by the Equitable (vide infra)-a conclusion that the PR refrains from making.
    c. This is just one aspect of a more general conclusion from the PR: "Certainly the Society's single with-profits fund incorporated a very wide range of different types of business: traditional life products, pensions products and pure investment products, domestic and overseas business, and even within policies of the same class there were often widely different types or levels of guarantee. The Society's bonus declaration resolutions ran to many pages of detailed allocations varying in kind and value. The system depended on the exercise of the management's wide undefined discretion and resulted in impenetrable complexity" (P20.10). That complexity became as impenetrable

from within the Society as from without, for reasons explained under Corporate Governance below, and it all had the effect of precluding effective scrutiny.

d. It also reflects the difficulties in equity and potentially excessive mutual insurance that can result from the indiscriminate placement of different policy types and maturities in one pooled unitised fund. Many aspects of this emergent situation had already been foreseen and criticised by the actuarial discussants of the WPWM paper in 1989 and 1990 (EARW section 3 p7-8; Appendix 1). Of this Lord Penrose says: " At the inquiry reference date of 31 August 2001 there were therefore in issue pension contracts (a) incorporating an implicit guaranteed roll-up investment rate of return, and a guaranteed conversion rate in possession comprising a fixed rate of interest and a pre-determined mortality factor; (b) incorporating an explicit guaranteed investment rate of return and an explicit expenses deduction*; and (c) without guaranteed rates of any kind. In the remainder of this section discussion relates to the pensions business, with particular reference to retirement annuity contracts, since that was at the heart of the *Hyman* case and was thought to lie at the roots of the Society's difficulties at the reference date. However, there were guarantees in other classes of business, and contrasts within similar groups of business. For most of the relevant period, endowment assurances reflected implicit guarantees of investment return in the guaranteed sum assured. Premium scales were constructed by adding together a charge for the basic benefit and a loading for profit participation. In contrast, in 1990 the Society introduced recurrent single premium life contracts with no guaranteed growth at all. Most business of this kind was sold in the form of single premium bonds. The variety of contractual rights among policy types participating in the with-profits fund was considerable" (P2.50).

43. As initially explained, examination of the regulatory position is a secondary objective of this article. But with regard both to PRE and the official Opposition case for organisational and operational regulatory failure (32 below), readers are invited to consider the PR's extensive quotations (P13.107-12) from a memorandum dated 21st Sept 1987 by George Newton, who was directing actuary for the insurance directorate at the Government Actuary's Department (GAD) from 1982-8. Newton clearly described a desired and responsible regulatory position despite contemporary uncertainties over the definition and importance of PRE. This position had both prudential and conduct of business implications, and some of his specific concerns were highly relevant to the Equitable. Readers are invited to consider whether history has since proved him right, and if so why the position was not followed up following his departure.

**The official Opposition view of regulatory failure:**

44. The extract below is from pages 2 and 3 of Andrew Tyrie's letter to Parliamentary Ombudsman Ann Abraham: "Lord Penrose's Report identified regulatory failure both of the system of regulation and of its operation over a sustained period, and particularly throughout the 1990's. These are documented in detail in, among others, Chapters 15 to 18. No doubt you will already be examining Lord Penrose's findings of regulatory failure in the short period covered by your first report, from 1st January 1999 to 8th December 2000. The scale of the regulatory failure identified by Lord Penrose prior to that period, and the accompanying detail he provides, also require investigation. Of the whole period Lord Penrose states: "There was a general failure on the part of the regulators and the GAD" (P chap 19.40). He writes of 1998, that "GAD's approach over this period seems to me to have been persistently naïve" (P chap 15.78). In his conclusions, he describes the Department for Trade and Industry and the Treasury ( who were between them responsible for prudential regulation from the early 1980's until 1st January 1999) as "ill-equipped" (P chap 19.158) and the GAD as "complacent" (P chap 19.160). Lord Penrose notes "short term objectives related to the support of solvency should have alerted regulators to the Society's

weakening position" (P chap 19.187). He says that "information was not used to form a realistic appraisal of the society's financial position" (P chap 19.209) and that "unsatisfactory answers were accepted without follow up" (P chap 19.228).
The events described by Lord Penrose which led to these and other conclusions of regulatory failure are very extensive. Among those which would benefit from investigation for maladministration are that public bodies:

- allowed the Society to accumulate huge contingent liabilities by selling unguaranteed policies without ring-fencing the funding of Guaranteed Annuity Rate (GAR) policies and without declaring that those prior guaranteed policies existed;
- failed to discover that the Society was not reserving for the guarantees expressly contained in the GAR policies;
- endorsed the Society's attempt to redress the balance by paying differential bonuses, later ruled illegal;
- permitted the publication of inadequate accounts and the submission of inadequate regulatory returns which obscured the financial weaknesses of the Society;
- failed to recognise the inadequacy of the reinsurance policy negotiated to cover reversionary bonuses for GARs in late 1998 and early 1999;
- allowed the Society to "over-bonus" for many years;
- allowed the Society to trade with totally inadequate reserves and to claim throughout that they were selling a low-risk product, coupled with prudent management and the benefits of mutuality

The GAD was the subject of particular criticism by Lord Penrose. In your first report you took the view that the GAD was outside your jurisdiction and gave your reasons. I strongly urge you to reconsider that view. etc."

At this point we may profitably revisit the axiom that: "no regulatory apparatus can function any better than the milieu in which it operates." Attitude and milieu would seem to be closely allied. If so, attitude as well as its milieu may be reflected generally, such that individual personnel may not be wholly or even largely accountable for a collective stance. Even so, stance and attitude must be expected to exert a major influence on operational characteristics independently of the organisational environment. Hence, although Lord Penrose did not single out individual regulators for criticism, that should not be taken as proof that there was no operational deficiency. Not surprisingly this position, when advanced by Treasury Minister Ruth Kelly in the Equitable March 24th 2004 Commons debate, was effectively demolished by various opposition MP's, who made a strong case for operational failure, let alone any systemic deficiencies. For further analysis of regulatory failure please see the Level 2 narrative account.

**Expansion and inflation.**

45. Though it does not often say so directly, the PR implies that the Equitable did not fully appreciate the increased volatility of its equity portfolio, or the fundamentally inverse relationship between inflation and interest rates. And in fact the PR account would itself be much strengthened were it adjusted for monetary inflation and the explosive growth in sales and of the membership. This would make the underlying financial weakness and the failure of reserves to increase *pro rata* more insightful.
46. Given the Society's commitment to expansion, it might be expected that the large new sales tail would wag the dog in various ways, e.g. development of a sales-orientated culture, higher fixed costs, and an inevitable drive to maintain and increase sales (e.g. by over-bonusing) which could become an end in itself and steadily erode financial strength. The PR shows that effectively this is what happened. Despite the Society's published claims for high administrative efficiency and low expense ratio, Lord Penrose states: "The contractual expression of expenses, as 4½ % of contributions, did not reflect accurately the acquisition cost of new business. The actual cost was considerably higher (for actual yearly management expense ratio figures see P tables C2-4). The Society developed the mechanism of an internal "new

business loan" to capitalise the excess un-recouped acquisition costs with a view to recovering them over the anticipated life of the contract"(P6.15). Was this over and above the inappropriate quasi-Zillmer adjustment used for a similar purpose?

47. With regard to these points, there is a need to investigate the influence of the sales and marketing function on the Equitable's business policy, and any active contribution it may have made to actuarial policy as defined in the "With Profits Without Mystery" approach at executive or Board level.
48. With marketing objectives in mind, it is not unreasonable to assume that "deliberate cross-generational subsidy" of mature GAR policyholders was aimed more at getting and holding onto inward transfers under corporate and group schemes than at individual private clients. The wooing and winning of influential and powerful group scheme friends (whose administrators and Trustees could themselves have been of suitable age to benefit from Equitable flexibility) might also be expected to confer incidental benefits on the Society, its officers and directors. And given that the FSSU (Federated Superannuation Scheme for Universities) business needed retaining or replacing, this was more than usually important. Under these circumstances, there would have been a bias against less mature and private policyholders. One such example of this bias is the extension of GAR privileges for group scheme clients from 1988 to 1993 (P2.43-4).
49. Remarkably, the PR makes no reference to the With Profits Fund degenerating into a Ponzi scheme, or the similarities between the Equitable Bubble and the Lloyd's "recruit to dilute" campaign. This is despite the writer having submitted the *prima facie* evidence for fraudulent mis-selling contained in an earlier paper entitled: "THE EQUITABLE LIFE DISASTER; DOES IT COMPARE TO THE LLOYD'S ASBESTOSIS SCANDAL OF THE 1980'S?" to the Penrose Enquiry, receipt of which was specifically acknowledged on Feb 11th 2002. This paper, based on an earlier letter to the Society and which was developed with the assistance and advice of Michael Josephs, became at his further instigation the starting point for EARW Section 6. The Lloyd's "recruit to dilute" campaign has aptly been described as a Ponzi scheme; the Society's version of a Ponzi scheme has been earlier described in the Level 2 narrative section of this paper.

**Sophistry, mythology, propaganda, misrepresentation and mis-selling.**

50. The PR's main description of the WPWM manifesto is given in P4.1-11 and 25-6. It does not examine the manifesto in relation to the Society's history prior to 1970 in much detail, and does not reveal that it is a set of interdependent sophistries of plan and practice which are antithetical denials of lessons previously learned. Nor does it stress the coherence, consistency, duration and "totality" of the wrongs that resulted. As previously shown, these sophistries do not withstand searching examination (EARW sections 3 & 4 and main points summary above). The PR does, however, repeatedly allude to a complementary Equitable mythology, e.g. "Policyholders were encouraged to take the view that the Society's practice was to allocate all available surpluses as they arose, subject to a degree of smoothing, in contrast to other offices that withheld benefits that should have been available from current surplus. This approach, and the absence of a free estate, was presented as being a continuation of an approach that dated back to the establishment of the Society in the 18th century, although this was part of a mythology that was build (sic) up over the period covered by this inquiry" (P19.8 & 4.4-5). This was a carefully disingenuous misrepresentation which has further implications for PRE, issues of duty and good faith, and mis-selling generally. With regard to the *post hoc* nature of the WPWM paradigm, Lord Penrose says: "By 1990 the weakness of its (i.e. the Society's) balance sheet was well advertised: *With Profits Without Mystery* adopted the inevitable outcome of this approach as policy" (P6.98).
51. Here recall that Roy Ranson had been similarly disingenuous in front of an actuarial audience when closing the Edinburgh discussion of the WPWM paper in 1990: *"Regarding the estate, of course we do not have objections to its existence and of course if it exists it is of value to existing policyholders, but I will keep asking the questions: - who created it, which generation, and why was it created? Those points*

*need to be taken up and answered. What contribution is required towards it from the current generation? When are the holders of estates going to tell the public what it is all about? How did they have this flash of inspiration to create it and who paid for it? Who is going to go on paying for it? As a matter of interest I did not inherit one so perhaps that influenced my views"* (my italics). As we have seen, he could say this because Sherlock and he had already distributed the Society's estate. And in point of fact the estate concept had originated at the Equitable itself no later than 1775 (EARW Section 3 p8-9).

52. Overall, it is thus not surprising that Lord Penrose should at a later time say that the Society (presumably as a whole) was a victim of its own propaganda. <u>But this does not explain the origins of propaganda, or why it was formulated by an influential minority with crucial knowledge- who are likely to be the same set of instrumental members on the "senior management team" referred to in 14 above.</u> As to its effect on policyholders, he says: "It would be inappropriate to summarise the whole correspondence received. These examples (pertaining to non-GAR issues- MN) illustrate a wide-ranging problem associated with policyholder discontent focused on the Society's products, marketing and sales processes, and the management of its distribution policies (this can only be construed as a polite euphemism for general mis-selling- MN). The attitudes towards the Society that the correspondence displays are in no small part a reaction to discovery that the myths the Equitable spread about its unique and highly superior ethos were not soundly based on fact" (P chap 8.61). <u>What the Society's former ethos had been, and how it was traduced during the last 30 years of its existence, is indicated by the postscript to this article.</u>
53. We also need to know why the important details of the WPWM approach, and particularly those referred to under the PRE heading above, did not come through in sales literature, product particulars and contracts, and why (as is emergent common knowledge) branch offices and representatives remained in ignorance of them. Moreover, although Society literature stressed the absence of commission, presumably external, internal incentives were paid to sales staff: "Sherlock recruited Ken Wills as marketing manager. Wills introduced a "commission" based remuneration scheme for sales staff, superseding a limited incentive scheme that had been introduced in 1970 by Ogborn. On 25th September 1974, a new performance-related bonus system for the sales force was recommended" P chap 3.18) So, what percentage of the value of sales was this at different times? <u>"Incentivised ignorance" of sales staff thus remains an outstanding issue (EARW Section 8 p 16).</u> Sadly the PR has not addressed "incentivised ignorance" in any way.
54. In his postscript (chap 20.79 & 80) Lord Penrose says: "…Any court or other adjudicator resolving issues of duty, or professional conduct, will require to make an independent assessment of the facts, in default of agreement, and that may agree or disagree with the views I have expressed. Policyholders, in particular, must not base their expectations on the report beyond what it offers: my best assessment of the evidence I have recovered …" and: "…A hard lesson for many has been that it is the nature of a mutual with-profits office that the members have little recourse to anyone other than the other members for recovery of their losses. I am in no position to make any general finding as to the manner in which this aspect of their investment might or might not have been drawn to their attention; that depends upon what they were told individually and what they understood at the time, and it is clear that individual cases differ…" But this does not entirely gainsay Lord Penrose's authority and official standing, or what unites all cases, i.e. the general nature of the disinformation and misrepresentation as exemplified in the Society's and director's public statements, literature, and sales training platform. Individuals' corroboration of this is therefore merely a concluding formality. <u>Sufficient evidence has long been available for the burden of proof to have passed to the Society and the FSA, who should demonstrate that its statements, literature and sales pitch were a true representation of a normally functioning with-profits fund, that the fund did not lose its essential with-profits characteristics by 1982/3 following a selective dispersal of its estate, that it was not thereafter trading on a false basis because it was relying on unrepeatably boosted performance figures and did not cross over into a with-liabilities fund by 1987 at the very latest, and that at no time did it degenerate into an expanding and liability-diluting Ponzi operation implemented by an ignorant sales</u>

force. Much trouble would have been saved if the FSA and the Society had made an appropriate demonstration earlier on, and so one can only conclude that this was, and remains, impossible. And all this begs the question as to why Lord Penrose did not consider that he should make further use of his considerable learning and authority.

55. With this in mind, note that in connection with Headdon's maxwellisation submission Lord Penrose concludes in chap 19.133: "…Nor do I accept his contention that the selection of a bonus policy was a separate issue from how it was published. That there are different processes is clear, *but in a mutual society there should be no difference between the substance of a policy and what is communicated to policyholders about it"* (my italics). In effect this is succinctly because in a mutual society: "…the persons with whom business is done are the persons for whom business is done" (P9.7). Moreover the law of equity here has particular application to the Society over and above its mutual status. In any commercial transaction there must be "good faith", and in the case of an insurance society there must be the "utmost good faith". The Society is open to the charge that it committed the tort of deceit of the policyholders by withholding information which, under the doctrine of *uberrimae fidei*, i.e. utmost faith, it should have supplied.
56. Re. 54 above, one may take a similarly sceptical view of the Financial Services Authority's recent announcement that it has conducted its own investigation and concluded that there had been no general mis-selling by the Equitable. That natural scepticism is increased by a refusal to publish the findings on which their conclusion is based. Besides, such an investigation was most urgently required prior to the Compromise Scheme. (The writer had therefore urged first the FSA, and failing their reply Sir Howard Davies in person to determine whether or not general mis-selling had occurred by quickly inexpensive yet adequate criteria in a letter dated Nov 28th 2001.) One must therefore ask what purpose is now being served by giving the public a wrong answer, and far too late in the day.

**Corporate governance and management culture.**

57. The Equitable originated in London in the year 1762. Its long association with the central establishment there is reflected in the names and locations of its London Offices. In 1993, besides its Registered Office at 4 Coleman Street EC2R (later re-located to City Place House, 55 Basinghall Street EC2V 5DR) it boasted no less than 6 London branch offices:
    a. "Bank" at Birchin Court, Birchin Lane EC3V 9DJ
    b. "Central" at 13 Hanover Square, W1R 9HD
    c. "Law Courts" at Crown House, 51 Aldwych, WC2B 4AX
    d. "Minster Court" at 1 Minster Court, Mincing Lane, EC3R 7AA
    e. "West" at First Floor, Ryder Court, 14 Ryder Street, SW1Y 6QA
    f. "Westminster" at Southside, 105 Victoria Street, Sw1E 6QQ.

    There were 20 regional offices in the rest of England: Birmingham North, Birmingham South, Brighton, Bristol, Cambridge, Chelmsford, Epsom, Exeter, Guildford, Leeds, Liverpool, Maidstone, Manchester, Milton Keynes, Newcastle, Nottingham, Sheffield, Southampton, St Albans, and Windsor. Outside England there were offices in Belfast, Edinburgh, Glasgow and Cardiff ("South Wales"). From this it appears that, besides the capital, there was a preponderance of offices in the South East.
58. If the bridge of the Good Ship Equitable was Coleman Street or Basinghall Street, and most closely associated with the 6 London branch offices, the engine room was (and is) the Chief Administrative Office at Walton Street, Aylesbury, Bucks HP21 7QW. This was the powerhouse and headquarters of the executive function.
59. Back now to Lord Penrose, who relates that: "Until 1967 the Board of Equitable Life excluded current executives of the Society, including "the Actuary and Manager", from appointment as director. When Henry Tappenden retired from office as Actuary and Manager he was appointed executive director, and retained some executive duties. This marked the first departure from established practice. In the following year Tappenden retired from all executive duties, but executive representation on the

board was firmly established with the appointment of Maurice Ogborn, Tappenden's successor as Actuary, to the Board in 1969. From that time, executives came increasingly to take part in the direction of the Society. But it was to be some time before that was reflected in any fundamental change in attitude. Peter Martin, an experienced solicitor who was to become vice-president in time, told the inquiry that when he joined the Board at the beginning of 1984 it was his impression that the Society was governed very much by an old-fashioned "gentlemen and players" culture in the form that it had been since it was constituted in 1762 (the period was somewhat exaggerated). The Board consisted of City professionals with no specific life assurance expertise (mainly bankers and stockbrokers) who invested the premiums. There was little connection culturally between them and those executives who were based at Aylesbury. I accept his statement as reliable. The role of the executive was wide, and included management of the sales force, product design and administration, and the actuarial valuation of the liabilities and provisions that quantified the long-term fund and, by comparison with the assets of the Society, the surplus available for distribution" (P9.20, 21).

60. At this stage, therefore, there were limits to an ambitious executive's rise within the echelons of the Society. But thereafter things changed, and throughout the late 1970's and early 1980's there were generally three executive directors in a board of ten or eleven. Marketing manager Ken Wills joined in 1976, as did non-executive Professor Roland Smith. Ranson, who entered the Equitable in 1951, had to wait until 1985 before he became an executive director. During Smith's presidency there were as many as five executive directors, and "….it was Martin's impression that the character of the Board had changed. There was a movement towards creating a modern Board that operated as a single cohesive body. The "gentleman and players" culture was breaking down. Non-executive directors were drawn from a wider background, and there were efforts to bridge the cultural divide……" (P9.25).
61. The writer maintains that these changes may have come at a price. Provided that they satisfied the expectations of their non-executive colleagues and the interests they represented, executive directors might now look to form advantageous links outside the Society, and assist one another in this aim. Influential outside interests would also have dealings with the more important branch offices, and most notably the London ones.
62. <u>It is a matter of concern that one of the creators of WPWM, who may have owed feudal allegiance to Ranson, ran the Systems and Controls Review Group (SCRG) (P chap 9.52) the purpose of which was to manage risk and counter fraud, and that Ranson maintained that SCRG's responsibilities were executive, and not a Board matter.</u> Julian Hirst, the Society's chief accountant at the time, told the Inquiry that: "The remit (of SCRG) was different to that of an internal audit function- its remit was to ensure compliance with office principles and policies and to assist management" (P chap 9.52; also ¶ 49, 50,129). <u>This smacks of control and censorship of information flows.</u>
63. <u>It is also a matter of concern that besides risk management and SCRG, product design and the entire WPWM concept were executive matters into which the Board of Directors had no real input. Lack of relevant expertise in the non-executive directors was a material contributory factor</u> (P19.90).
64. Lord Penrose has also commented on the disjointed and fragmentary nature of information given to the Board by the executive. "...As a result of this practice…even if directors had all the relevant pieces of the jigsaw, they were most unlikely to have been able to piece them together and form a picture of the totality" (P19.85). This we should set against the following statement by Roy Ranson in closing the Edinburgh discussion of the Ranson & Headdon paper: "The Paper covers practically the whole range of activities associated with the operation of a predominantly with-profits office. *The kind of points made through the paper are discussed with the Board and senior colleagues very much in the way we put them in the Paper (the wording is a bit different on occasions) and to the extent that we can, with policyholders. That of course is a difficult exercise but we are making efforts.* (EARW Section 3 p8) " Of course this statement is also relevant to PRE.
65. The PR has specifically examined only the executive roles of Ranson, Headdon and Nash, but feudatory allegiances and management culture in the actuarial, sales and

marketing functions may deserve further general consideration. So do officers' and directors' mutually beneficial relationships with influential external connections. In this regard and with benefit of hindsight Sherlock's appointment as inaugural head of LAUTRO (Life Assurance and Unit Trusts Regulatory Organisation) looks inappropriate. Lord Penrose has also refrained from commenting on the role and significance of WPWM's joint creator, who was assistant general manager and SCRG head David Driscoll, or how Ranson's own feudatory allegiances progressed, e.g. in his relationships to Sherlock, Wills and Smith, or to Maurice Ogborn before them. The most straightforward current interpretation of Nash and Headdon's predicament is that they were feudatories (i.e. vassals) of Ranson, who were left exposed by his retirement in 1997. The consequences of these relationships for the Society may have been accentuated because Ogborn, Sherlock, Ranson, and Headdon successively combined the responsibilities of Actuary and Managing Director. For a general discussion of the feudal nature and external relationships of organisations see EARW section 5 p 12.

66. The Institute of Actuaries has taken a less lenient view than the PR, and as related on page 10 of "The Actuary" for August 2004 has instituted disciplinary proceedings against Sherlock, Ranson, Headdon and Nash. Suffice it to say that the charges generally reflect much of the evidence presented here, but that in addition:
    a. Of Headdon: "the signing, in April 1999, of a side letter to the Society's reinsurance agreement with ERC Frankona, which was relevant to the value attributed to such agreement in the regulatory returns, without disclosing such side letter to the regulator;"
    b. Of Nash: "authorising and signing a letter to policyholders dated 1 February 2000, upon which policyholders were likely to rely, that allegedly misrepresented the Society's position in the event of its appeal to the House of Lords failing;" (For further discussion of this misrepresentation and its effects see P chap 8.18, or EARW section 7 and 10 ¶ 3 for an explanation of its essentially fraudulent nature).
67. Management culture may be relevant to why actuary Andrew Soundy made no headway with Headdon and Ranson when protesting the unfairness of the GAR Differential Terminal Bonus policy in 1993-4 ( P. Chap 1.9). Conversely, it may also explain why Soundy could take over risk management and report to Julian Hirst in 2000 (P9.179) after SCRG was disbanded in 1999 (Ranson having retired in 1997). In ¶ 180 Lord Penrose continues: "The domestic solution developed by the Society in 2000 with the assistance of Ernst & Young was ample. Subject to reflecting generally accepted contemporary views, *there appears to be no reason why the Society could not have developed and comprehensive audit committee function and associated internal audit at any time during the 1990's had there been the will to do so. It appears that the lack of progress towards that end can only be attributed to the intransigent resistance of the executive to what was regarded as an attempt by the Board, or particular members of it, to encroach on what had come to be regarded as management's exclusive area of interest* (my italics). Having regard to the articles of association, the notion that delegation to the executive could ever be exclusive of the continuing supervision of the Board, and to recall should that course seem appropriate, was at all times wholly without foundation."

**Loss and harm suffered by policyholders:**

68. Lord Penrose's remit has not permitted him to say much about the harm done to policyholders, either collectively or individually. He estimates that the Society was short of 4.4 billion pounds in 2000/1. This estimate does not include restoration of estate or reserves. Equally importantly, it does not include liabilities for residual inequities of guarantee, and most notably the GIR issue*. Nor does it address the continuing harm and difficulties resulting from the New Board being obliged to run the remnants of the with-profits fund on the discredited WPWM paradigm in order to maintain technical solvency. For a more detailed explanation of these issues than what has initially been summarised, and more minute categories of loss and damage, please refer to the itemised listing in EARW section 11. Some of the more important

points are also placed in Level 2 narrative context in the section entitled: *Compromised.* The current version of this article does not expand on the consequences of regulatory failure given there.

**Conclusion:**

Though the constraints upon Lord Penrose may disappoint those who hoped his Report would be more positively judgemental, it is a substantial and informative work. It adds much supportive detail to relevant lines of investigation. Yet as we have seen, there are significant gaps in its coverage. The most important of these stem from reluctance to examine the common factors underlying defects in the Society's conduct of business, and the role played by its sales and marketing function. In following this up it also has also become clear that the way the Society managed its relationships with corporate/institutional scheme administrators, Trustees and their consulting actuaries has seriously disadvantaged private members. These inequities and their regulatory implications, which relate both to prudential management and conduct of business, now require urgent investigation.

It also remains important for groups and individuals to stress why the PR has not been able directly to address issues of faith and duty, negligence, maladministration, non-disclosure, misrepresentation, deceit, mis-selling, and fraud in their correspondence with the Society, Financial Ombudsman Service, the Serious Fraud Office, FSA and regulators. To that end, this article now includes evidence and material relevant to these categories. Specific instances of breaches of faith and duty, misrepresentation, non-disclosure and deceit in support of an untenable overall position are given. The evidence augments EARW sections 7 and 8 which respectively deal with fraud and mis-selling, and it reinforces the prior conclusion that the overall coherence, consistency and duration of the Society's stance and conduct have been tantamount to fraud. That conclusion is in any case inevitable once it is accepted that the entire WPWM fund and business paradigm is an elaborate sophistry. And quite simply, after 1987/8 at the latest, fraud clearly did occur. Though more detailed confirmation is needed, the pivotal and deliberate nature of the events of 1987/8 categorises them as fraud of the first degree (cf. EARW Section 7).

It has also become clear that the Society's and its officers' relationships with corporate and institutional schemes, their trustees, actuaries and advisers is a serious but sensitive issue. Private members without such influential representation, information and protection have been relatively disadvantaged, but it remains unclear to what extent. This unexplored new area also has ethical, professional standards and regulatory dimensions, and the likelihood is that ongoing inquiries will not have the scope or remit to address them. If so, further representations will be necessary.

For these and many other reasons it is correspondingly important to remain alive to the continuing harm arising from the Compromise Scheme's failure to rescind the WPWM paradigm. And though we cannot expect direct explanations in the PR for what it could not address, there are as we have seen indications as to what the overall motives for the situation may have been. Patently they merit further attention by the appropriate authorities. But whether these will materialise is doubtful, because the governmental and regulatory milieu was, and remains unsatisfactory. This is indicated by the following:

- Disenfranchisement of WP annuitants in the so- called Compromise Arrangement was legally permitted.
- Prior to the Compromise the Government and Treasury deliberately ignored the case for liability-diluting general mis-selling, and its implications for legal action and solvency (EARW section 2 p 5)
- So did the FSA, and eventually Sir Howard Davies in person, who specifically acknowledged receipt of the relevant material from the writer on Nov 28th 2001.
- As related above, the Penrose Enquiry also received, specifically acknowledged, and then ignored the same material after the Compromise.
- The Penrose Inquiry has been limited in its powers and remit.
- As explained, regulatory failure has been total.

- The Parliamentary Ombudsman's first report on the Equitable was manifestly unsatisfactory. It required judicial review proceedings by the Equitable Members Action Group and pressure from the Opposition to make her re-open her inquiry (For details go to www.emag.org.uk)
- As lately as 9th July 2004 the declared aim of the Financial Ombudsman Service has been to relate redress to the terms of the Equitable's B& W Deloitte and their own Jonathan Hirst opinions, with supplementary comments on Hirst from Christopher Carr and Gabriel Moss, who have previously provided opinions on behalf of the Equitable. Moreover, the likelihood is that most cases will be judged only in relation to the GAR issue, unless claimants have provided specific evidence or requests to the contrary. Following the appearance of the PR the FSA has granted he Society a temporary waiver in relation to some of its findings so as to give it time to consider its reply (for details see www.fsa.gov.uk./register/pdf/A27762P.pdf). The FOS have also advised that any modification to claims will not be considered unless the Equitable have had an opportunity to respond to the new evidence first. The writer has complied with this, and urges others similarly placed to do the same promptly if they have not already done so.
- The Chancellor of the Exchequer, who became Architect General of the current pensions crisis when he withdrew tax relief from pension fund earnings in 1997, and whose ministry is responsible for all the relevant regulation, has remained obdurately silent on the Equitable. He did not attend the March 24th 2004 House of Commons Debate, for which he was chastised by Shadow Chancellor Oliver Letwin. He has delegated the issue to Treasury Minister Ruth Kelly, whose stance on the matter is well known.
- As related above, the FSA has come to the wrong conclusion too late in the day with regard to prudential regulation, conduct of business and general mis-selling.
- Despite representations from Lord Penrose and action group members the Serious Fraud Office has not acted decisively, but has waited on the sidelines.

These are also the main reasons why the E7 group have faced an uphill struggle in getting attention or gaining redress for the consequences of Governmental and regulatory failure. Hence also their need to continue to make the case against the Society with regard to breaches of faith and duty, misrepresentation, concealment, duplicity, deceit, mis-selling and fraud in their negotiations with the New Board of Directors, and in their various law suits. They should also note that the Penrose report effectively ends at March 31st 2001, and continue to press their views on events after this without reference to the Report. Readers may now wish to return to the Finale of the Level 2 narrative, which essays a more wide ranging perspective.

Dr Michael Nassim. December 30th 2004.

* Opinions continue to differ on the overall effect of the GIR. Some take it at face value, and view it as a continuing if unfair advantage. Others, and most notably ELTA committee member Bill Davies, maintain that the way it is charged for and operated have been detrimental to GIR policyholders. For an explanation of his position see EARW section 10 p 17-18. Given the number of degrees of freedom the Society enjoyed in these circumstances, the matter may not be resolved decisively until there has been a suitably comprehensive investigation and explanation of the Society's practical operation of the GIR.

**Acknowledgements:**

The author remains indebted to his various collaborators, who are mostly in the E7 movement. He is especially grateful for pioneering work and data supplied by Nicolas Bellord on matters of good faith in relation to PRE, and collaboration with Michael Josephs on submissions to the Parliamentary Ombudsman and graphical presentation. He also wishes to acknowledge the latter's constant attention to the underlying importance of power and influence, which has continued to inspire and inform his thinking. Accordingly he wishes to dedicate the sections on PRE to Nicolas and the "Fat Cats and Poor Mice" chapter of the narrative to Michael. He is grateful to Andrew Tyrie for sending him a copy of his letter to Ann Abraham, and to those MP's who are continuing to press for a more appropriate and satisfactory resolution of the Equitable victims' predicament. The main action groups have been supportive throughout, and he wishes specifically to acknowledge Paul Braithwaite's and EMAG's contribution to the Parliamentary Ombudsman debate. But on this occasion his greatest debt must be to Lord Penrose for the latter's manifest integrity and the scrupulously robust nature of his deliberations, such as they are.

Dr Michael Nassim. December 30th, 2004.

**References:**

REPORT OF THE EQUITABLE LIFE INQUIRY. THE RIGHT HONOURABLE LORD PENROSE. ORDERED BY THE HOUSE OF COMMONS TO BE PRINTED ON 8 MARCH 2004. LONDON: THE STATIONARY OFFICE.
http://www.hm_treasury.gov.uk/independent_reviews/penrose_report/indrev_pen_index.cfm

Ogborn, ME: Equitable Assurances (The Story of Life Assurance in the Experience of the Equitable Life Assurance Society 1762-1962). George Allen and Unwin Ltd, London 1962.

With Profits Without Mystery. Roy Ranson and Christopher Headdon. J.I.A. 116, 301-345 (1989). This includes the London discussion. See also: T.F.A. 42, 139-186 (1990), which records the Edinburgh discussion. .pdf files available *via* the Resource Centre button on the Faculty of and Institute of Actuaries website http://www.actuaries.org.uk

The House of Commons March 24th 2004 Equitable Life Debate.

An Equitable Assessment of Rights and Wrongs. Dr. Michael Nassim. Jan 12th 2004. http://www.Elta.org.uk

The Equitable Life Assurance Society. The alternative Penrose report (22nd Dec 2003), and other papers. Colin Slater (Burgess Hodgson Chartered Accountants). In: the Vital Documents listing on the EMAG website: http://www.emag.org.uk

The Equitable Life Disaster- Does it compare with the Lloyd's asbestosis scandal of the 1980's? Dr Michael Nassim, Nov 14th 2001.
http://www.cookham.com/community/equitable/michaelnassim1.htm

The Corley Report. 28th Sept 2001.
http://www.actuaries.org.uk/Display_Pagecgik?url_/life_insurance/corley.xml
(or: Vital Documents Section of EMAG website.)

The Baird Report. 16th Oct 2001.
http://www.hm_treasury.gov.uk/newsroom_and_speeches/press/2001/press_113_01.cfm

Equitable Life: An Evaluation of the Financial Position of Equitable Life for the Equitable Members Action Group. Cazalet Consulting. In: Vital Papers section of the EMAG website: http://www.emag.ork.uk

Mr. Justice Langley's Strike Out Judgment of October 17th 2003, paragraphs 49–58.
http://www.cookham.com/community/equitable/langleyletter:htm

Parliamentary Commissioner Act 1967.
Terms of reference and Statement of Complaint for the Equitable Life Investigation.
http://www.ombudsman.org.uk/pca/document/equitableSOC04.htm

The Actuary: August 2004, page 10.

**POSTSCRIPT.**

**Extract from 1825 report from the Court of Directors in rebuttal of some members' requests for a further distribution of surplus (M.E.Ogborn: « Equitable Assurances » pages 182-3).**

"The great and leading principle of this Society has ever been its *Equity*; it has persevered for sixty years in a "regular course", by which its security and stability have been confirmed: it has answered all its engagements, and afforded greater benefit than any other Institution of a similar nature; and it will continue so to do, if the same prudent and beneficial course is pursued. Why then should any doubts be suggested, any wavering in principle be excited, or any *new plans* of management be proposed, which cannot offer such experience, and which may require to be altered as speedily as they might be adopted? Let us not then lower the dignity or reduce the benefits of this Society, by a surrender of its mature and venerable character, for any charms which a more modern garb may display.

The general utility of the Society, the advantages it realizes, and the good faith with which its engagements have been performed, and which have induced and still induce new Members to join and support it, might be destroyed if any essential principle were to be altered, without considering the risk of legal, or perhaps of parliamentary interference…

Before the Directors proceed to state their opinion upon specific *suggestions* brought under this consideration, they earnestly entreat the attention of every Member of the General Court; and they wish to impress on their minds what was the origin of this Society, what its distinguishing feature from almost every other Society, and what has been *their* inducement for joining it; and, they believe, that of the majority at least, if not all its Members. It has been an anxious desire to provide for the comfort of others, to extend blessings and protection to the widow and orphan, and to assist, as far as pecuniary relief would afford it, to lighten affliction and relieve distress, and to procure support for those who may have lost their natural guardians and protectors. It never could have been the intention, as it never has been the practice, to make it a subject of speculation, or an object of personal and selfish advantage; and if any have joined it in that expectation, it is the duty of those who are actuated by *superior* motives, to rally round their standard, and to support and protect its proper principle, and its most important object"

Given the eventual disastrous plundering of the estate and its consequences, this text reads both as epitaph for the Old Equitable and prophesy for the New. The final irony is that the New became the antithesis of the Old over a mere 20 years, while continuing to exploit the latter's unrivalled reputation. And whereas formerly the Society's stewards had vigorously protected it from the rapacious excesses of its owners, latterly the owners have needed (and may indeed further require) protection from their stewards. Any failure to appreciate this is a sign of our times. M.A.N.