

Equitable Life Assurance Society

And

Its Handling of With-Profits Annuities.

CONTENTS

The report, which is in 4 sections, is meant to be read in sequence but each section is also written to be self-contained. As a consequence, there is some duplication but that is a penalty worth paying to ease the burden of digesting the entire report at one sitting. But many of the conclusions described in Section 1 are only explained in the detailed text of the following sections.

Section 1 Conspiracy or Cock Up? A review of the events over the last 15 years, the consequences for the With-Profits Annuitants and the failure of the Society and the various regulatory authorities involved.

- 1.1 Introduction
- 1.2 What Happened
- 1.3 The Compromise Deal
- 1.4 Conclusions

Section 2 The Impact of the so called “20% and other Reductions” on Annuitants. A description of all of the reductions that have been made to the annuities since 2000, besides the well publicised and in some respects least understood “20 % reduction”

- 2.1 Introduction
- 2.2 The Equitable Life Annuity
- 2.3 The “20% Reduction”
- 2.4 The “Other Reductions”
- 2.5 Summary

Section 3 Things you should have known about your annuity but didn’t know enough to ask. An explanation of the different elements of the ELAS annuity and their inter-relationships.

- 3.1 Introduction
- 3.2 The Equitable Life Annuity
- 3.3 How the ELAS annuity works
 - 3.3.1 The Overall Rate of Return and the Total Return for a Level annuity
 - 3.3.2 The Anticipated Bonus Rate and the Declared Bonus Rate
 - 3.3.3 The Interim Rate and the Overall Rate of Return
 - 3.3.4 The Overall rate of Return
 - 3.3.5 The Compromise Deal
- 3.4 Summary

Section 4 How it Works and How it’s Done. A detailed technical description of how the annuity system appears to work.

- 4.1 Introduction
- 4.2 The Data
- 4.3 The Equitable Life Annuity
- 4.4 The Method
- 4.5 The Model
- 4.6 General Rules about With-Profits Annuities
- 4.7 Life Expectancy
- 4.8 Summary

Basic Guaranteed Annuity (BGA); Declared Bonus Annuity (DBA); Total Guaranteed Annuity for the year (NGA); Final Bonus Annuity (FBA); Total Gross Annuity (TGA); Anticipated Bonus Rate (ABR); Overall Rate of Return (ORR); Declared Bonus Rate (DBR); Total Return for a Level Annuity (TRL)

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To all of the above my thanks and appreciation,

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Equitable Life Assurance Society “Conspiracy or Cock-Up”

1.1) Introduction

The Equitable Life Assurance Society (ELAS) has received very wide and adverse publicity for its actions over the last few years. **What** has been done is reasonably clear, but **how** and **why** the Society chose to adopt certain strategies has never been satisfactorily explained.

I volunteered to collect data from annuitants to study the impact of the reduction after the Society announced that it was reducing the payments to With-Profits Annuitants (WPAs) by 20%. My objectives were to determine if there were any patterns and to predict what the reduction might be where it had not occurred already. Subsequently I extended these objectives to understand the possible future impact on annuitants' pension payments and explain what had hitherto been contained in the Society's marketing literature, but either largely misunderstood or not comprehended.

The current jargon term for much of what has occurred is called ‘Confusion Marketing’, not so much because there is an overwhelming selection of choices and options as there is not. It is because the terms and terminology used by the Society are imprecise, arguably poorly phrased and rarely explained at a level that enables the clients to actually really comprehend the consequences of the decisions being made that have had and will continue to have such a profound impact on their future financial security. As more and more of the implications of the Society's pre-sale marketing activity and their post-sale activities over the last 15 years are understood, including some very misleading material presented at the time of the so called "Compromise Deal", it is easy to understand why annuitants are angry and frustrated and demanding action by the Society, the statutory regulator and the government.

The Society appears to have structured the With-Profits Annuities in a manner that enabled it to present them as producing very good benefits, but without explaining the downside risks. These risks were identified in 1989 at a meeting of the Society of the Institute of Actuaries when the original paper “With Profits Without Mystery” was presented by the Society, before the initial offering of this new type of annuity. The members of the institute were quite severe in their criticism of the paper but, so far as can be assessed this was broadly ignored by the Society and the official regulator.

The With-Profits Annuities are also structured to enable the Society to remove entirely a very large portion of the annuity that is “un-guaranteed” in order to meet its other obligations as they arose following the consequences of the GAR litigation and the subsequent House of Lords adjudication, the collapse of stock market prices and the general fall in interest rates over the last 15 years.

It would appear that this **crisis was not entirely un-anticipated by the Society** and one which should have been known to the FSA, or its predecessor, **but no action appears to have been taken.** This has left one section of the Society's clients, the With-Profits Annuitants, exposed to, what has been felicitously phrased, Institutional Exploitation with substantially reduced incomes and without the possibility of recovery.

1.2) What happened?

Over the last 15 years, there have been many events that taken in isolation might be regarded as of no consequence, chance acts, things that just happen in any organisation that has to operate in changing times managed by people who are at least as prone to error and mis-judgement as everyone else. And there can be no doubt that one possible explanation of all the things that have happened or not happened can be explained quite easily by what is known in the vernacular as “The Cock Up Theory of Life”.

On the other hand, when all the actions are put together there does appear to be the semblance of a pattern.

1) In the late 1980's the Society decided to withdraw the GAR product since according to the Burgess Hodgson report, the Society was beginning to encounter financial problems. (See the note at the end this Section)

2) At about the same time, the Society introduced an innovative concept under its own title, which was the With-Profits Annuity. The logic was that the annuitant could benefit from increasing stock market values and dividends that otherwise were retained by the annuity provider. This must have been and in some respects still is a very attractive proposition. **What was not apparently explained to the purchasers of the Society's annuity at the time was that whilst their income was higher than it might otherwise have been, much of that income over time was to be classified under the terms of the annuity as "un-guaranteed"**.

In the process of data collection, it became clear from the communication with Guaranteed Interest Rate (GIR) annuity holders that they neither knew that they had contracted to this type of annuity, nor fully understood the how the Total Return for a Level Annuity (TRL) was derived until this project was started! Many of these annuitants apparently did not understand that they were offered a Guaranteed Interest Rate (GIR) of a 3.5% uplift on their Anticipated Bonus Rate (ABR) to create the much higher Total Return for a Level Annuity (TRL),

The term TRL more or less describes what it means. That is if the Society achieved a consistent Overall Rate of Return (ORR) that was identical to the TRL, then the annuity would remain constant and level.

The ORR itself has never been adequately defined and is set by the Society based on its own internal computations, without reference to the policyholders and members, ignoring that they are the people most affected by any changes in its level from year to year.

Apparently, it was not made clear that the un-guaranteed element of the annuity would become an increasingly large percentage of the total income of the annuitant nor that it could be removed in its entirety. In effect the Society, intentionally or otherwise, had created a vast source of assets that, whilst apparently assigned to the annuitants as future benefits, in reality could be removed at any time. Such an act would substantially and immediately reduce its future liabilities.

It would be interesting to understand how this was recorded in the accounts of the Society, since it is not immediately obvious when an un-guaranteed liability is a commitment to pay in the future unless the Society decides otherwise, becomes a real liability in a true accounting sense. **It is understood that no provision appears in the Society's accounts for this un-guaranteed bonus element despite its appearance in the annual statements sent to policy holders** and despite it accordingly forming part of Policy Holders Reasonable Expectations under insurance legislation.

Further, because this un-guaranteed element was "intended for" policy holders by way of bonus, it is arguable that the legislation concerning statutory accounts for life insurance companies has for many years required such non-guaranteed bonuses to be provided for. However, they were not and, so far as is known, are still are not in the Society's accounts.

3) In the mid 1990s, it would have been obvious that the Overall Rate of Return (ORR), required by the GIR type annuities, was not sustainable and that they would inevitably pay a reduced amount each year. From a marketing perspective this was presumably not acceptable and this type of annuity was withdrawn and replaced by a non-GIR annuity. The significant difference being that the TRL was set as equal to the ABR. So even though the Overall Rates of Return being achieved by the Society were lower than they had been historically it meant that the annuity would still increase whilst avoiding the declining results of the GIR annuities AND retaining the primary benefit to the Society of creating another source of assets that could be withdrawn.

This remixing did not affect the ORR being declared by the Society.

4) By the late 1990's the Society was in serious trouble and there followed a series of apparently unrelated events as follows:

The Society had historically sent out details of the various 'rates' it was using for the year, the Overall Rate of Return (ORR), Declared Bonus Rate (DBR) and the Interim Rate (IR) The year 2000 was the last year for which these details have been issued and without these it is not possible for the annuitant to know what rates are being used by the Society. Despite repeated requests for this information, none has yet been received. It can be derived if there is enough data from enough annuitants and expertise in computer modelling, otherwise the annuitant not only does not know, but also cannot find out.

There is no obvious reason why this information should not be available to annuitants. Given the mutual status of the Society and the position of each member as both a co-insurer and an insured with all the other members, it seems doubtful that the Society can be justified in withholding this information. It is closed to new business, so the information cannot be commercially sensitive.

Since this time there have been substantial changes, in practice severe reductions, in all of these rates.

a) The Overall Rate of Return (ORR) has been reduced from an average of just over 10% for the preceding decade to respectively 7%, 3% and 2%. This change reduces the amount of annuity being paid.

b) The Declared Bonus Annuity (DBR) has been reduced from typically 5% for non-GIR policies, and 1.5% (5.0 less 3.5) for non-GIR policies, was reduced to zero. This has NO effect on the income of the annuitant but transferred large amounts of annuity into the 'un-guaranteed' element of the annuity that could be withdrawn by the Society at its own discretion.

c) Several events flowed from The House of Lords adjudication of the GAR bonus issue.

i) The Society reduced the Overall Rate of Return (ORR) by 1% in 2001 and 2002 and by 1.5% in 2003 and 2004. That is making further reductions in the income paid to annuitants.

ii) The Society produced and, after an extensive public relations campaign and approval by the Court, implemented the so-called Compromise Deal. As far as annuitants were concerned, the Society offered an uplift of 4% (0.5% for GIRs) on two elements of the annuity and 2.5% on the Total Gross Annuity. The 4% uplift had NO, and could not have had, any effect on the Total Gross Annuity paid. The 2.5% uplift, which would have had an effect on the amount of the Total Gross Annuity paid occurred in the same year that the ORR was reduced by 4%. Whatever the reason for the dramatic drop in the ORR, the Compromise Deal gave the With-Profits Annuitants (WPAs) absolutely nothing in terms of increased income. This was not what the literature implied.

iii) In November 2002, the Society produced the document entitled "Your With-Profits Annuity – planned reduction to income payments" a copy of which can be found at the end of Section 4. The entire document is a classic example of Confusion Marketing and whilst it must be admitted that after extensive analysis and communication with the Society the document does actually say what the Society intended, it was and remains far from clear. It is discussed in more detail in Section 2 but it would appear that the Society intends to exercise its option to remove the entire Final Bonus Annuity from the WPAs in two steps, one that is in process and will end early next year, when the next step will be implemented. The cumulative effect will be the transfer from the WPAs income from March 2003 until their deaths of approximately £1.8 billion pounds.

This facility that the Society has apparently created over the last 15 years in the way it set up its With-Profits Annuity schemes, is being used to address the problems, only partially caused by the House of Lords ruling on the GAR issue.

It would appear that not only has the Society had some very clear financial objectives since the late 1980's and early 1990's and that this process appears to be both exploited and continuing with the new board and under the supposedly close supervision of the regulatory authorities. It would appear that the Society designed the With-Profits Annuities with the intention that an increasing part of the annuity should become un-guaranteed and could be removed. The amounts that have been or may be removed is discussed in more detail in Section 2

It follows that there can be no doubt that another possible explanation of all the things that have happened or not happened can be explained quite easily by what is known in the vernacular as the "Conspiracy Theory of Life".

Which is the more correct interpretation is not possible to decide without full access to the Society's records and computer systems.

1.3) The Compromise Deal

It is arguable that the Compromise Deal would not stand up to legal challenge on the following grounds:

a) The full state of the Society's finances, in so far as they were disclosed, was in fact NOT as they were disclosed. The With-Profits Annuitants have gained nothing from the deal save perhaps to ensure the Society did not go into receivership.

b) The deal offered to GIR and non-GIR annuitants was perhaps an illusion and consisted of the following:

i) A 4.0% uplift on the Guaranteed Basic Annuity (GBA) and the Declared Bonus Annuity (DBA) (0.5% for GIRs). This was paid, but nobody until this research realized that all this did was to transfer money out of the Final Bonus Annuity (FBA) element into these elements. It had NO, repeat NO effect on the Total Gross Annuity (TGA) at all!

ii) A 2.5% uplift on the TGA. So the maximum uplift anyone could get was 2.5% and NOT 4.0%. But in the same year the Society reduced the Overall Rate of Return (ORR) by 4%, which obviously reduces the TGA, not quite by a corresponding amount but close to it.

The Society's Compromise deal offer actually gave the WPAs absolutely nothing in exchange except for giving up their rights to sue over mis-selling and a minor increase in their guaranteed annuity.

So this poses the question, would the annuitants have accepted the offer had we known what we know now? The answer is surely not since, apart from the above, there are facts that the Society knew, but had not disclosed - see the EMAG web site for hidden losses etc. (www.emag.org.uk)

1.4) Conclusions

It is arguable that the whole concept of the With-Profits Annuity is open to a charge of mis-selling since the investment of their savings of future and current annuitants was in a financial vehicle not that dissimilar from any other investment that is linked to Stock Market performance, with investments in high return, but high risk equities, and bonds. This is NOT the right strategy for a financial vehicle that is meant to provide stable income for pensioners. It is perfectly feasible to provide a With-Profits Fund, that permits the annuitants to benefit from both capital growth and dividends in good years and smoothed over bad year, without resorting to a high-risk strategy.

Anecdotally, an investment banker expressed the opinion that the function of the Society was to meet its liabilities with respect to pensioners and those building up retirement funds AND NO MORE. It was not the function of the Society to make risk investments that are more appropriate for other savings vehicles, such as PEP's, ISAs and the like. In his opinion, the Society took a very high risk investment strategy for reasons that are not relevant here and that not least was one cause of their problems.

One of the implied themes of this analysis and report is that the Society has been taking situations as they arise and developing policies to counter or minimize the effects and/or damage as the board perceived the problem. In a commercial organisation driven by profits, this is not only to be expected, but also demanded by its owners. But the

Society is not a commercial organisation. It is in fact a mutual Society which is supposed to be driven to meet the reasonable needs and expectations of all of its members. That it has failed in its primary function is hardly a matter of debate.

And that would have been that, the end of the analysis. And then quite by chance, following down another line of enquiry on the Internet I came across an article on the Investors Association web-site which in turn referred to a presentation made by the Society to the Institute of Actuaries on 20th March 1989 and titled 'With Profits Without Mystery' (Journal of the Institute of Actuaries, v.116 1989)

It is not the intention to critically review this presentation not least since the document and review is 30 pages long, but three elements that seem very pertinent to this document have been extracted. **As it happens members of the Institute of Actuaries expressed deep reservations about the 1989 paper as potentially exposing the Society to failure and collapse**, a forecast that turned out to be remarkably prescient.

"2.2.1 The fund is continually open to new members. In particular, we do not believe in the concept of an 'estate' in the sense of a body of assets passed from generation to generation and which belongs to no-one. This is a point developed later in the paper.

3.2.6 If one accepts that the policyholder's key concern is the total proceeds achieved, then the matter of how those proceeds are made up between declared and final bonus elements should be of secondary importance.

4.3.4 There is, however, a more fundamental issue to be addressed. Even if a better measure of strength could be made, it must be asked why strength is of itself a desirable feature. Clearly there must be an adequate level of strength or an office is at risk of having the DTI intervening in its affairs. However, beyond such a level of adequacy it is difficult to see the merit of strength as an end in itself. One must ask for whom the strength is being built up. There is an argument that a high level of strength could indicate a failure to achieve a full value return to policyholders although, of course, such strength does add to the office's freedom of manoeuvre. Whether that is desirable or not is a matter of judgement. In the extreme, maximum strength could be achieved by having no declared bonus and passing all the return on by way of a final bonus."

Of course, it is very difficult to be sure what was meant by something said 15 years ago, but one interpretation is that the financial strategy of the Society was to create a With-Profits fund where "strength" could be achieved by establishing a Final Bonus that could be removed at the Society's discretion and that Policyholders would not be concerned (*i.e. since they would not understand?*) how the proceeds (*i.e. the annuity?*) is made up. The Society's "Estate" (*i.e. its reserves?*) could be used for other purposes presumably in the promotion of the Society as a successful Life and Pensions company.

With the benefit of hindsight, maybe the paper should have been titled, "Without Profits but With Mystery!"

The Government employs actuaries in its service in the FSA today, DTI at the time, who presumably are professionally qualified, are members of the Institute of Actuaries and receive the Institute's periodicals. It follows that it is inconceivable that the regulatory authorities were unaware of the Society's strategy as presented by its Chief Executive and of the concerns expressed by the members of the Institute about the paper and the implied strategy and yet no action was taken then or since.

Whatever, the motivations of the individuals, separately or collectively, might have been at the time and arguably continue to the present day, whether it was some grand conspiracy or just a mixture of bad luck and incompetence, can be guessed at, but probably never truthfully exposed. And in some respects, it doesn't matter, since the impact on the With-Profits Annuitants of the Equitable Life Assurance Society is the same.

The FSA and its predecessors have clearly failed in their statutory duty to the public and those members of the Society – the With-Profits Annuitants, who are now expected to carry the costs of their administrative failure, have the right to and deserve recompense.

Note: Burgess Hodgson are a firm of Chartered Accountants, who produced a report of the Equitable Life With Profits Fund in March 2003 at the request of the Equitable Members Action Group. (EMAG). The report can be found on the Internet at: www.emag.org.uk/documents/03.pdf