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**“Interim Report 3.5” and Your Letter of May 4<sup>th</sup>.**

**Summary.**

The proposed counterfactual reconstruction of the Regulatory Returns is flawed for the following reasons:-

1. It does not counterfactualise very many highly salient issues known to have been discussed at meetings between the regulators and Equitable Life.
2. It does not make any *explicit* assumptions about the critical issues of the personalities and motivations of the regulators which would have impacted on the extent to which they acted in a forensic manner when regulating Equitable Life.
3. The history has an arbitrary start and end date defined by the Ombudsman's findings of maladministration. It fails to consider critical events outside these arbitrary dates.
4. The revised counterfactual history now asserts that Equitable Life would have developed a five-year recovery plan post-1990. No account is taken of important plausible effects (suggested by reference to the Ombudsman's Chronology) resulting from knowledge of the recovery plan entering the public domain.
5. Counterfactual reasoning is highly controversial. Nevertheless, we are led to believe that the actuaries involved have expertise in this area because they had experience in with-profits life assurance management. This claim is logically flawed. Errors made in counterfactual reasoning are cognitive errors made by many individuals, they have no obvious relation at all to experience in with-profits management.
6. Policyholders have no access to the detailed workings of Towers Watson or of the actuarial peer review of their work.
7. A proposal that policyholder advocates with expertise in with-profits insurance should be involved in developing the history has been rejected.
8. Very important parts of Towers Watson's counterfactual model are still being developed (specifically the impact of the recovery plan on income). Thus there will be important aspects of the model that policyholders will be unable to comment on. (This does *not* imply that the whole approach is in any way acceptable).
9. At least one of Towers Watson's basic assumptions - that policyholders had reasonable expectations (PRE) of “full and fair distribution” - is fundamentally flawed, as has been conclusively shown.

**There are clearly very many alternative pasts for Equitable Life absent maladministration, and no clear rules for choosing between such histories. This whole process must therefore be discarded and be replaced by an intellectually coherent and fair procedure for determining the causation of policyholder's losses.**

Dear Sir John,

I thank you for your reply to my previous submission, and for your copy of what I will term “Interim Report 3.5”. I will confine my comments to the counterfactual reconstruction of the Regulatory Returns.

In my two previous submissions I suggested that this process was methodologically flawed. I concluded in my most recent submission that:-

“For various different reasons, the counterfactual reconstruction of the Regulatory Returns outlined in Interim Report 3 is prone to serious challenge on the grounds that it is not soundly based. Moreover, given that the regulatory regime involved understanding issues which were not covered in the DTI returns, as well as prospective analysis of a life assurance company's future, the reconstruction of the Regulatory Returns in Interim Report 3 lacks highly salient information.

You may consider it essential, given your Government-derived Terms of Reference, that you are required to counterfactually reconstruct the Regulatory Returns, just as the Government recommended in its submission to you. However, if this approach is irrational, lacks intellectual coherence and results in what could be called a “solemn nonsense”, it must surely be discarded and be replaced by an intellectually coherent procedure for determining the causation of policyholder's losses?

I do not consider it at all implausible that, if the whole regulatory *process* (as opposed to the limited Regulatory Returns) was counterfactually reconstructed as it could have occurred, the final result might not have been very different.”

In your reply of May 4<sup>th</sup> you simply stated, very briefly:-

“In pursuing my Terms of Reference I think it is appropriate to focus on the Regulatory Returns. It was the Regulatory Returns that were the subject of the Ombudsman's findings of injustice; and, as is made clear in my Terms of Reference, my advice is sought on “the extent to which the Regulatory Returns would have been different if the maladministration accepted had not occurred.”

Thus you did not reply to my critique. It is appropriate therefore, in developing my critique further, if I now summarise where we have got to. In doing so, I think it is helpful to use the concepts developed by Donald Rumsfeld about the structure of knowledge – specifically the existence of “known knowns”, “known unknowns” and “unknown unknowns”.

### **Known Knowns.**

As far as the counterfactual reconstruction of the Regulatory Returns alone is concerned, the “known knowns” are:-

- i) That you are considering these Returns in isolation from the rest of the extensive regulatory process,  
and
- ii) Without considering the critical issue of the personalities and motivations of the regulators;

- and  
 iii) With arbitrary start and end dates, as defined by your Terms of Reference.

**Known Unknowns.**

In terms of the “known unknowns”, we know that the counterfactual history simply does not consider all the issues I discussed in my previous submission (see summary above).

In your reply to me of May 4th you wrote:-

“I am not seeking to construct a counterfactual history of the full regulatory history of Equitable as it should have occurred - as you suggest.”

However, this was *not* the main thrust of my argument, which was that reconstructing the Regulatory Returns alone was not intellectually coherent. I will try once again to convince you of this. The meetings that occurred between Equitable and the regulators covered a very wide range of topics, as I have previously demonstrated. To supplement the information already presented, I refer you to the Ombudsman's Chronology for 17/01/1992 (See Appendix 1) which details the Agenda for just one such meeting which covered *all* of the following as the “main areas” for discussion:-

1. Board of Directors
2. Management Structure
3. Future Plans and Strategy
4. The role of the Appointed Actuary
5. Decision Taking
6. Corporate Structure
7. Administration
8. Distribution Systems
9. Investment Policy
10. Bonus Policy.

It is clear that the very wide-ranging meeting was intended to, and clearly *could* well have covered topics involved in subsequent regulatory failure - specifically, the role of the Appointed Actuary and bonus policy. Although other topics on the Agenda, such as decision-making, future plans and investment policy, were so open-ended that, for a company which we know was under very close watch because of its unique business plan and lack of reserves (see my previous submission), clearly *could* have generated very substantial forensic investigation by appropriately motivated, highly skilled and informed actuaries. Clearly such investigation cannot have taken place given the subsequent state of Equitable Life.

I therefore repeat my assertion that the counterfactual reconstruction of the Regulatory Returns alone is intellectually incoherent. It is essential to reconstruct the whole regulatory process as it *could* have developed. As you think it is appropriate to focus on the Regulatory Returns alone you need to justify this argument, which you have to date singularly failed to do.

It is clear that, by reconstructing the Regulatory Returns alone, the current counterfactual history contains a very substantial number of “known unknowns”, and thus is quite simply invalid.

### **Unknown Unknowns (or Speculative Known Unknowns).**

The term “unknown unknowns” refers to events that were not conceived of by an observer at a given point in time. By definition, in constructing a counterfactual history there will have been events that were not anticipated by those constructing the history. Thus counterfactual histories have major issues in dealing with “unknown unknowns”. Nevertheless, I will try to describe some of the potential “unknown unknowns” that might have occurred. In this respect, I am possibly dealing with what could most accurately be described as speculative “known unknowns.” It should be noted that these events, although speculative, may have considerable impact. Thus they should probably be described as unknown low probability, high impact events. I now develop my methodological critique by considering some of the speculative events that might plausibly have occurred. These are based on the Ombudsman's Chronology.

Towers Watson’s revised counterfactual history now asserts that Equitable Life would have implemented a five-year recovery plan post-1990. We thus have to consider what might have happened had this recovery plan entered the public domain. If this suggestion appears irrational, I refer you to material in the Ombudsman's Chronology, dated 8<sup>th</sup> September 1992 (Page 85), where it is revealed that (with my emphasis):-

“A DTI supervisor telephoned an Independent Financial Adviser who had heard that the DTI were investigating Equitable and were requiring them to submit *quarterly* returns because of their solvency position. The supervisor explained that Equitable’s solvency cover had reduced and referred the Adviser to the society's 1991 returns.”

Thus we can plausibly wonder what informed and forensic Independent Financial Advisers (such as the individual revealed in the Chronology) might have done, and what effect this could have had on Equitable's reputation, new income, and withdrawal of funds had policyholders learned that Equitable had implemented a five-year recovery plan. Of course, we don't know what would have transpired, as this is by definition a “speculative known unknown”. Nevertheless, we do know that when it comes to matters of financial reputation a bushfire can spread very rapidly - witness recent events at Northern Rock. A rapid spread of such a bushfire is not implausible for a company which was known by the cognoscenti to have a unique and controversial business plan.

It is also highly relevant to ask what could have happened in this situation (with inquisitive, forensic IFAs) if Equitable had introduced the proposed five-year recovery plan. According to Towers Watson there was a 28% deficit in 1990 just prior to the onset of the plan. It is entirely plausible that in implementing this plan Equitable, appropriately regulated, would have had to impose a prolonged market value adjuster (MVA), and that this would have been a considerable MVA given the 28% deficit. The imposition of such a MVA would have sent a very clear signal to IFAs etc about the parlous state of Equitable at that time. This would have impacted on future income and withdrawals. Towers Watson acknowledge that their hypothetical five-year recovery plan would have resulted in “reasonably lower new business volumes”. However, they do not mention a MVA. Moreover, their work on this topic is still such that they state:- “We have not completed our analysis”. Thus policyholders are to be denied the opportunity to comment on this important topic before the publication of

your final report. It is relevant to note that when Equitable imposed a MVA following closure it caused complaints to the Office of Fair Trading, adverse reports in the financial press etc. It is also relevant to note that the introduction of a MVA should have enhanced GAD's regulation (absent maladministration) of an already high risk company, leading to all sorts of potential changes in Equitable's counterfactual history. (It is important to stress here that although I am proposing an alternative to the Towers Watson scenario, this in no way implies that I believe the counterfactual approach is credible).

The Chronology also reveals that on the 27<sup>th</sup> August 1991 a Scrutinising Actuary made a telephone call to Equitable posing as a potential policyholder. Equitable subsequently wrote to the actuary at his home address with details of their with-profits bonds. It is therefore relevant to ask what such Scrutinising Actuaries might have done anonymously had they heard of the five-year recovery plan and had there been no actuarial maladministration. Would they have made much more incisive "mystery shopper" enquiries about Equitable's behaviour/solvency? Of course, we cannot know as this is again a "speculative known unknown".

The two examples above of "speculative known unknowns" will suffice. There is no need to produce any more. **Clearly events at Equitable could have developed in very many different ways absent maladministration. There are no clear rules for differentiating between these pasts.**

In support of this very fundamental claim, I refer you to:- "Counterfactual History: A User's Guide" by Martin Bunzl, Professor of Philosophy at Rutgers University, USA, as published in the American Historical Review 2004. See <http://www.historycooperative.org/journals/ahr/109.3/bunzl.html>.

He wrote (with my emphases):-

"Is there a respectable basis for counterfactual reasoning in matters of history? Or is such reasoning what E. H. Carr dubbed *a mere "parlor game"*?"

*Historians approach counterfactual reasoning with enormous unease, and they do so with good reason. The rhetoric of historical methodology makes evidence central in a foundational conception of the discipline, and (direct) evidence is just what you can't have for claims that are by definition contrary to fact...*

One of the problems of counterfactual reasoning in an even partially deterministic world is that *one change begets another*. Considering what would have happened but for the occurrence of an event leaves us with a choice that ranges between keeping everything the same or changing *all* the interconnected events that *led* to that event. Where we come down on this choice will have repercussions on whether the consequent of the counterfactual follows from the antecedent.

*But changing the past to make the antecedent plausible quickly deprives us of our sense of certainty".*

**It is very clear that any counterfactual analysis is prone to serious challenge.** However, we are led to believe that the actuaries involved are not only mathematically skilled, but that they have solved all these theoretical issues. You wrote that:-

“It is possible for actuaries with practical experience of with-profits life assurance business at the relevant time to make an informed assessment as to what would have been likely to happen. This has been done. I am satisfied that – within the limitations which are inherent in what must be a counterfactual exercise - it is appropriate for me to rely on the revised scenario.”

Of course, the major problem with this analysis is that the limitations of the counterfactual exercise are simply not known. Just as the Treasury would be outraged if the counterfactual analysis concluded that Equitable should have been closed in, say, 1980 (I am assuming here that you are going beyond your Terms of Reference, as you have done in the past), likewise policyholders will undoubtedly be outraged if their compensation is small as a result of the current Towers Watson scenario.

Moreover, in so far as I can tell, the faith in Towers Watson's and their actuarial peer reviewers' intellectual powers is purely that – faith. Nowhere do you justify that faith. There is an enormous academic literature on counterfactual thinking. See, for example, <http://www.socialthinking.org/CRN/cfbibl.htm>. Whether or not Towers Watson have referred to any of this literature is totally unclear. We are, nevertheless, to be denied sight of their *detailed* assumptions (although in their paper they do define a considerable number of *basic* ones), or of the peer review of this controversial work. I attach in Appendix 2 a critique of your basic assumption that a cohort of experienced actuaries is necessarily an appropriate group of people to give you an accurate assessment as to what could have happened at Equitable Life absent maladministration.

I note in passing that one of Towers Watson's basic assumptions is that:-

“The regulator would have been concerned with policyholders' reasonable expectations (PRE), and that for Equitable Life these expectations included “full and fair distribution”.

My colleagues have already demonstrated to you in considerable detail that PRE for policyholders did not involve “full and fair distribution”, as this concept did not appear in much of the company's literature. In contrast, policyholders had PRE that there was a smoothing policy, a concept which regularly appeared in the company's literature but was lacking in Equitable's performance. The persistence of the allegation that policyholders knew all about “full and fair distribution” despite substantial evidence to the contrary casts doubt on the good faith of those conducting the counterfactual exercise. I make no comment *at all* on Towers Watson's many other basic assumptions.

**To conclude, I repeat my contention that Towers Watson's approach in following your Terms of Reference is irrational, lacks intellectual coherence and results in what could be called a “solemn nonsense”. It must be discarded and be replaced by an intellectually coherent procedure for determining the causation of policyholder's losses.**

Yours sincerely,

Dr A J Goudie

**Acknowledgements:-** Although this is a personal submission, I am deeply indebted to my policyholder collaborators:- Dr Michael Nassim, Nicholas Oglethorpe and Michael Josephs.

## **Appendix 1.**

### **Extract from the Ombudsman's Chronology.**

17/01/1992

GAD write to Equitable's Chief Executive to announce that they intend to visit in the near future. GAD explain that this is part of the DTI's and GAD's rolling programme of visits to insurance companies authorised to write long term business, that it is the intention to visit all offices within three years, and that no significance should be attached to the order in which the visits take place.

GAD say:

We would like to discuss the following main areas:

1. Board of Directors
2. Management Structure
3. Future Plans and Strategy
4. The role of the Appointed Actuary
5. Decision Taking
6. Corporate Structure
7. Administration
8. Distribution Systems
9. Investment Policy
10. Bonus Policy

## Appendix 2.

### **A critique of the idea that a cohort of actuaries would necessarily provide an informed, accurate assessment of the counterfactual history of Equitable Life.**

As already indicated in my previous submissions there is now a considerable literature on the cognitive psychology of thinking demonstrating that all humans routinely make substantial errors and show many cognitive biases. It is therefore relevant to consider how such errors and biases impact on the behaviour of experts, as in this case the various actuaries are being presented as experts in counterfactual thinking.

An important recent book in this area is:- “Expert Political Judgment: How Good Is It? How Can We Know?” by Professor Philip E. Tetlock, Haas School of Business, University of California, Berkeley (2005). See:- <http://press.princeton.edu/titles/7959.html>. See also [http://repository.upenn.edu/cgi/viewcontent.cgi?article=1056&context=marketing\\_papers](http://repository.upenn.edu/cgi/viewcontent.cgi?article=1056&context=marketing_papers) for a review by S. Armstrong, Professor of Marketing, The Wharton School of The University of Pennsylvania (2007).

As an experimental cognitive psychologist Tetlock conducted a very extensive 20 year study of the ability of 284 experts in political science and economics to predict future events. A key finding, based upon no less than 82,000 forecasts, was that the experts barely outperformed informed non-experts.

A second key finding was that individuals had different cognitive styles, and that this impacted substantially on the accuracy of their predictions. Tetlock drew attention to Isaiah Berlin's (1953) metaphor derived from Greek poetry:- “The fox knows many things but the hedgehog knows one big thing.” Foxes draw upon many ideas and sources of information; hedgehogs interpret the world using their favourite theory or dogma. Foxes are more tolerant of ambiguity and uncertainty than hedgehogs, who tend to be confident about the rightness of their view of the world. Tetlock showed experimentally that foxes usually outperformed hedgehogs, producing more accurate predictions.

As far as counterfactuals are concerned, Tetlock noted (see <http://press.princeton.edu/chapters/s7959.html>) that:-

“Hedgehogs are more likely than foxes to uphold double standards for judging historical counterfactuals.”

Since it has been argued by well-respected cognitive psychologists that the cognitive processes involved in thinking about the past are highly likely to be the same as those involved in predicting the future (Byrne RMJ, Behavioural and Brain Sciences, 2007, 30, 439-480), the conclusion to be drawn from Tetlock's work in the current context is that the accuracy of a counterfactual history will be determined not by whether “expert” actuaries had experience in with-profits administration, but by whether their cognitive styles are those of foxes or hedgehogs, which of course we do not know. It is highly unlikely they have examined this question. Poorly performing hedgehogs are individuals who “know one big



thing” and “interpret the world using their favourite theory or dogma”, it is simply possible that all the actuarial counterfactualisers are hedgehogs.

As Byrne (2007 - see above) noted in a major review:- “People exhibit remarkable similarities in the sorts of things they change in their mental representation of reality when they imagine how the facts could have turned out differently.” She also noted:- “There are many examples of the counterfactual imagination producing irrational outputs (page 452). However, we are currently led to believe that actuaries can all transcend these basic cognitive issues. I see no reason at all why experience in with-profits management enhances the ability to construct a counterfactual history by changing basic cognitive processes.

**Of course, as I have in this submission proposed what are, in my opinion, various plausible alternatives to the Towers Watson scenario, it is clear that such comments apply to me also. But this is of limited relevance, as I am not posing as an expert on counterfactualisation, in direct contrast to the various actuaries involved.**