The Actuarial Profession
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Report of the Corley Committee of Inquiry

regarding

The Equitable Life Assurance Society

September 2001

REPORT OF THE CORLEY COMMITTEE OF INQUIRY REGARDING THE EQUITABLE LIFE ASSURANCE SOCIETY

On 21 December 2000, the Actuarial Profession announced that it was setting up an independent Committee of Inquiry to look into the events surrounding the closure of the Equitable Life Assurance Society to new business and its implications for the profession. The inquiry was asked to focus in particular on the key issue of professional guidance and to report its findings to both of us.

We both welcome the report and we wish publicly to thank Roger Corley and the members of his committee for the enormous amount of their hard work in producing it. We are committed to the rapid implementation of the report's recommendations, some of which the profession is already actively pursuing.

The report will be of interest to a wider audience than Appointed Actuaries of life companies and for this reason and in a spirit of openness it is entirely appropriate to publish the document in full.

We encourage readers to study the report in its entirety so that its recommendations are read in context. The document and other supporting material can also be found on the profession's website at www.actuaries.org.uk/life_insurance/corley.html.

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COMMITTEE OF INQUIRY INTO IMPLICATIONS FOR THE ACTUARIAL PROFESSION OF EVENTS LEADING TO THE CLOSURE FOR NEW BUSINESS OF THE EQUITABLE LIFE ASSURANCE SOCIETY

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Note: In this report the accepted accounting term ‘provision’ is used in place of the traditional actuarial term of ‘reserve’.

Summary of Recommendations:

We recommend that:

A. **the Faculty and Institute, in their current investigation into ways of monitoring compliance with professional standards, make an external peer review of the work of the Appointed Actuary a requirement.** (paragraph 34)

B. **the provision of an annual Financial Condition Report be made mandatory.** (paragraph 35)

C. **the Guidance Notes refer specifically to open-ended guarantees and their potential impact on the financial condition of a life insurance company.** (paragraph 39)

D. **the Guidance Notes make plain that the Appointed Actuary should require that there is a process for reviewing communications to policyholders and potential policyholders. The process should embrace:**

   (i) stated principles that the illustrations and other literature must reflect, and
   (ii) a consideration of how a policyholder who is not familiar with the constraints on a life office might read them. (paragraph 51)

E. **the Guidance Notes have more explicit references to the formulation of bonus recommendations to directors, maybe through a separate section. This section should include some wording that when a new with-profit product is introduced, the Appointed Actuary should consider whether it should join an existing common bonus pool.** (paragraph 54)

F. **the Guidance Notes require that, when advising the Board on policyholders' reasonable expectations or any successor concept under insurance regulations, the Appointed Actuary should ensure that other relevant strategies for meeting them are presented to the Board for discussion.** (paragraph 60)

G. **the Guidance Notes should require that an actuary resists holding the dual role of Chief Executive and Appointed Actuary or any role which compromises his or her ability to fulfil the duties of the Appointed Actuary.** (paragraph 68)

H. **the Guidance Notes require that, in the fields where the Appointed Actuary is responsible for making recommendations to the Board, the reasonable alternative courses of action with their advantages and disadvantages should also be set out.** (paragraph 75)

I. **the wording of GN1 and GN8 be reviewed to ensure that they are expressed in a clearer and more user-friendly manner.** (paragraph 81)

COMMITTEE OF INQUIRY INTO IMPLICATIONS FOR THE ACTUARIAL PROFESSION OF EVENTS LEADING TO THE CLOSURE FOR NEW BUSINESS OF THE EQUITABLE LIFE ASSURANCE SOCIETY

Background

1. On 21 December 2000, the Faculty and Institute of Actuaries announced that an inquiry would be held into the events surrounding the closure to new business on 8 December 2000 of the Equitable Life Assurance Society, with a view to determining whether there were any implications for the profession. (See Appendix 1)

2. On 19 January 2001 the Terms of Reference for a Committee of Inquiry were published together with the names of its members. The Committee was asked to report to the President of the Institute and the President of the Faculty, with recommendations if appropriate. (See Appendix 1 and paragraph 3 below)

Approach

3. The Committee's task was to study the sequence of events and determine whether there were any lessons for actuaries, and particularly whether the Guidance Notes which the Faculty and Institute provide to the profession needed any amending, strengthening, extending or rewriting. We have considered guidance within the context of current regulations. The Terms of Reference for the Inquiry were to:

   (i) Review the adequacy of the professional guidance in relation to the events leading to the closure of the Equitable to new business

   (ii) Consider whether there are any implications from those events of relevance for the roles of Appointed Actuaries and other actuaries who are directors or senior employees of long term insurance companies

   (iii) Make recommendations to the Presidents of the Faculty and Institute of Actuaries.

   This was an Inquiry of limited scope and the Committee had limited powers. The scope was to review, with the benefit of hindsight, the adequacy of professional guidance and the implications to the role of actuaries. The Committee's primary task was not to set out a definitive history of events, or to explain fully what happened and why, nor to reach conclusions about the conduct, performance or competence of the Equitable, its board (executive and non-executives), management (collective and individual), auditors, outside professional advisers or regulators. Nevertheless, the Committee considered it necessary to reach some understanding of events at the Equitable since 1956.

4. Guidance Notes relating to the responsibilities of the Appointed Actuary, a role formally established in 1973, are those known as GN1 and GN8. GN2 is also of interest in this context. Because the Equitable's Accounts under the Companies Act 1985 rely on actuarial calculations, GN7 is also relevant. These calculations are determined by the 'Reporting Actuary', who may be, but does not have to be, the same person as the Appointed Actuary.

5. The Committee concentrated on the period from the introduction of the first relevant contracts in 1956 up to the judgment by the House of Lords in July 2000.

6. The Committee met on a number of occasions to discuss the relevance to actuaries of the history of events and to interview some of the people who have been involved. Between meetings the Committee was effectively in continuous session through the medium of e-mail. However, it has taken longer than was first envisaged to complete the report. At an early stage the Presidents were advised that an extended timetable would be required and they have been kept informed of progress.

7. The Committee wrote to a number of senior actuaries with a wide spread of experience to ask for views on the lessons that might be learned by actuaries from their perception of the sequence of events leading to the closure to new business. In the letter asking for a response, it was recognised that some of those approached might have difficulty in replying either because they had insufficient knowledge of what had happened or because they were in some way involved in the recent legal processes. For these reasons the Committee promised that none of the letters received would be published without the writer's consent.

8. In the event, we received thirty responses. We found these responses, both as individual contributions and collectively, very helpful. A summary of the issues raised by respondents and others appears in Appendix 4. The names of these contributors and of others to whom we owe sincere thanks appear in Appendix 10.

9. We had the benefit of unsolicited letters, of letters that have been published in *The Actuary* and elsewhere, and of many informal discussions with actuaries and others.

10. On 27 March 2001 the Interim Report of the Treasury Committee of the House of Commons was published. We have taken note of the whole of this document and believe that to the extent that they fall within our Terms of Reference, we have covered those recommendations (a, c and e) which are specifically addressed to the Faculty and Institute of Actuaries.

11. We have reviewed the submissions of the Equitable, of the Financial Services Authority (FSA) and of the Faculty and Institute of Actuaries to the same Committee. These three documents, and other freely available written material which we have considered are listed in Appendix 9, together with an indication of where they can be found.

12. Our work was assisted by the co-operation of a number of past and present senior managers, actuaries and directors of the Equitable, and we wish to record with thanks their readiness to help the Inquiry. The Committee had no power to compel evidence (oral or documentary) and it has not raised formal questions with, or invited comments on any of its recommendations from, any particular individuals.

13. Because of the limited scope of the Inquiry, the Committee has approached its task on the basis that it should be sufficiently confident of the broad accuracy of its understanding of events before

drawing conclusions as regards the adequacy of guidance and the lessons to be learned about the role of actuaries. A substantial amount of information has been received and considered. For the sequence of relevant events we have relied to a substantial extent on the Memorandum from the Equitable to the Treasury Committee of the House of Commons, listed with other source documents in Appendix 9. This information has been supplemented by discussions with a number of individuals associated with the company. However it remains likely that there are facts and explanations of why certain decisions were made which, had they been known to us, would have affected this report in some way. Other inquiries with greater powers are being conducted and they may uncover aspects of the story which would have influenced us.

14. Our terms of reference are directed to considering actuarial guidance. We had no power to accuse, or to excuse, any individual or group of individuals, nor would we wish to have been given that power.

15. We considered that our duty was to report the apparent facts, and the conclusions that we could draw from them. If there is any culpability to be worried out of the events at the Equitable, it must be left for another forum and a different process to find it.

Events since 1956

16. The Committee believes that a statement of the relevant events since 1956 is essential for an understanding of what subsequently happened.

17. This report sets out the main threads of the events relating to the Equitable, as the Committee understands them. A more complete account of the evolution of Guaranteed Annuity Rates (GARs) is given in Appendix 2. To complement Appendix 2, Appendix 3 provides a summary of the principles used in valuing the liabilities.

18. The earliest form of GAR offered by the Equitable to its policyholders was a premium-based guarantee. This promised to a policyholder an annuity of X per annum from age 70, where X depended on the amount of premium paid and age at the date of payment. But the form of GAR which eventually created problems for the Equitable was of a different kind; this was based on a declared cash value of the policy (i.e. the benefit was illustrated as a cash amount and the guarantee related to the terms on which this cash could be turned into an annuity). The transition from the premium-based guarantee to a guarantee related to an annuity option on an accumulated fund was a response to a succession of Finance Acts. These first allowed a part of the proceeds of a policy to be taken as a tax-free lump sum. Later they permitted the accumulated fund to be used to purchase a pension annuity from any provider, the 'open market option' or OMO. Until 1988 the Equitable continued to offer policyholders the option of making further investments in any year up to their retirement on terms that included these GARs (an open-ended option).

19. For the purposes of this Inquiry, it would seem that there are several critical events: the granting of premium-based guarantees and open-ended options from 1956; the introduction in 1971 of a tax-free lump sum as an alternative for part of the benefit; the high inflation rates and interest rates of the seventies, leading to the increase in the guaranteed annuity rate; the introduction of terminal bonus in 1975; the introduction of OMOs in the 1978 Finance Act with the consequence that the Equitable then related the guarantee to the terms on which the cash value of the policy benefit could be turned into an annuity; further legislation in 1988 changing the format of pension policies leading to the Equitable no longer granting GARs on new policies and modifying the

terminal bonus structure; interest rates first falling below the rate reflected in the GAR in 1993; and market annuity rates falling from 1998 onwards to a level significantly below the GAR.

20. The Committee looked at each of these events. Our assessment is set out in paragraphs 37 to 75.

Some General Comments

21. The Committee noted several more general matters, which provide an important context for its assessment of the critical events.

22. The first is that the Equitable was unusual, if not unique, amongst mutual life insurance companies, in that it did not maintain a free reserve or 'Estate'. The Equitable philosophy on bonus, which complemented this stance, was that each generation of policyholders should get its own 'asset share', and neither inherit from the past nor give to the future. The Equitable gave a detailed account of its philosophy in a paper to sessional meetings of both the Institute and the Faculty of Actuaries in 1989, listed in Appendix 9. The discussion on the paper shows that the philosophy had both supporters and detractors. In its evidence to the Treasury Committee the Equitable has explained that each with-profit policyholder has a stake in the overall with-profit fund and that the eventual benefits received in the form of annuity or cash value should, so far as is possible, reflect the policyholder's notional share of that fund.

23. The philosophy of not retaining profits to build up an Estate proportionate to the fund contributed to the declaration of bonus that was seen to be higher than that declared by other life insurance companies. The larger bonus materially contributed to the effectiveness of the sales force in acquiring new business and, through the consequent high volumes, to the low costs of administration. This generated a momentum that boosted the overall efficiency.

24. In the long term there is trade off between a policyholder's expected total return and the security of the policyholder's benefits. The absence of free reserves meant that the company lacked a potentially valuable instrument to cope with unforeseen financial problems as compared with other mutual life insurance companies which had built up free reserves.

25. A feature of the Equitable's liabilities was the very high proportion represented by a single product range: the individual and group personal pension plans. These plans carried the GARs and some contained the open-ended option to invest further sums in the plan on the same terms as applied to the original investment. The Committee is not aware that any other UK life insurance companies granted to policyholders quite such advantageous terms or assumes that, if they did, they were able to dilute the risk through greater diversity of product.

26. The Equitable brand was second to none in the market place. The fact that the Equitable paid no commission and did not trade through independent financial advisers was one of its strengths. However, this also meant that it did not meet most of the competition head on in the market, and the independent financial advisers made few searching comparisons between the Equitable and the commission paying life companies. As a result of what we have been told by many of our respondents, we believe that this allowed the Equitable to adopt some policies and practices which were not prevalent elsewhere in the life insurance industry.

27. Another feature at the Equitable was a move against the trend elsewhere when, in 1991, the roles of Chief Executive and Appointed Actuary were combined. The roles remained combined until 1997 when there was a change of Chief Executive.

28. Of the factors set out in the immediately preceding paragraphs, there is not one that the Appointed Actuary or any other actuary need necessarily have changed. However, the unusual combination of the open-ended nature of the guarantees, the size of the GAR business in relation to the whole, and the absence of an Estate inherited from the past could well have been, and perhaps was, of concern to actuaries and to the Board.

29. The Committee believes, on the basis of what it has read and been told, that the main reason for the readiness of the Equitable to feel able to accept the risks was that its management had determined, after it had introduced the terminal bonus, that such a bonus provided the substantial flexibility required. This flexibility could, in its view and if the events ever so required, permit adjustments day by day, policy by policy and even according to the decision each policyholder made about which annuity to purchase when the time came to convert the policy into an annuity. Therefore, unless circumstances arose which resulted in no terminal bonus payment, the Equitable believed it could rely on adjusting the level of terminal bonus so as to provide for the full cost of meeting the GARs. A form of differential adjustment was apparently accepted (see paragraph 42) in the seventies when GAR policyholders who had premium-based guarantees were awarded an additional final bonus to make up for the fact that the contractual annuity rates were below those available in the market, whilst policyholders who opted to take a part of their benefit in cash did not receive extra bonus on this element. It seems that no-one raised an objection to this differential adjustment to the final bonus.

30. We did consider whether the course of events in relation to the Equitable would have been changed if the work of the Appointed Actuary had been subject to peer review. If this had been an internal peer review, carried out by a member of the Equitable staff, it seems unlikely that he or she would have challenged any one of the decisions made as being outside a reasonable range.

31. An independent actuary, with appropriate knowledge of practice elsewhere, performing an external peer review might well have found grounds for challenging the Equitable's philosophy and practice. It is possible that the Appointed Actuary would then have faced some questions by the management and Board on why the Equitable was taking a different path from its contemporaries. However, it is also possible that the answers would have been considered satisfactory, but the exposure of the points of difference (if any) and their resolution, might have introduced an additional control into the management and Board process.

32. The Equitable did adopt practices in a number of areas which we believe were different from the practices generally adopted by other insurance companies and therefore might have been highlighted in external peer reviews:-

    (i) in using terminal bonus adjustments as the means for meeting the cost of guarantees.

    The Equitable philosophy could resist challenge as long as a peer reviewer accepted that the Equitable had reasonably concluded that it was entitled to make the terminal bonus differentially variable, and that such variations were in line with PRE, where PRE means policyholders' reasonable expectations as described in the Insurance Companies Act 1982. Nevertheless there could still be scope for a difference of views

on the need to identify such guarantees in the FSA returns and the need to provide for them within the net premium valuation basis.

(ii) in various technical assumptions.

Appendix 4 identifies several points that an external peer-reviewing actuary might have raised as ‘points of exception’. It is possible that the assumptions used by the Equitable were perfectly permissible. However it is also possible that the valuation of the liabilities would have had to be strengthened (that is, increased) following a peer review. An increase in the value of the liabilities would have reduced the distributable surplus of assets over liabilities, leading to a reduction in bonus. This, in turn, could have caused a reduction in the growth of new business.

(iii) in the reporting basis in the Companies Act Accounts.

The Equitable was distinctive in reporting to its members on a ‘gross premium valuation’ basis. Whatever the technical merits of this basis as being more ‘realistic’ than the ‘net premium valuation’ basis required for reporting to the FSA, reporting in the Annual Accounts on a different basis from the rest of the industry raises communication issues (for an explanation of the difference between gross and net premium valuation bases, see Appendix 3).

33. The Committee is unaware that the non-executive directors, the auditors or the regulators (all of whom might be considered to be performing a form of external monitoring function) saw reason to challenge the Equitable’s judgement on any of these matters.

34. On the evidence before us, we conclude that an external peer review could possibly have made a difference to the course of events at the Equitable up to 1999, but not necessarily so. In particular it might have drawn attention to areas of significant differences with practice elsewhere. We believe that an external peer review can have value and could strengthen the effectiveness of the Appointed Actuary system. The Appointed Actuary might well benefit from talking to an actuary with relevant experience gained outside the organisation. The Committee recommends that **the Faculty and Institute, in their current investigation into ways of monitoring compliance with professional standards, make an external peer review of the work of the Appointed Actuary a requirement.**

35. A Financial Condition Report presented to the Board, as described since 1996 in GN2 as recommended practice, might have opened up the subject of risk and such a report would also be invaluable in an external peer review. We therefore recommend that **the provision of an annual Financial Condition Report be made mandatory** (except in defined circumstances) even if its format remains a matter of best practice.

36. We note that there has been much confusion in securing a public understanding of the reporting of various liabilities over the course of the last two years and that the Equitable itself has tried to rectify this in its Accounts for the year 2000. Much of this confusion stems from the inherent differences of approach in calculations of the liabilities for reporting statutory solvency, market value and best estimate. We recognise that this point raises issues which lie outside the scope of Guidance Notes and outside our Terms of Reference and which are already widely acknowledged by the accounting and actuarial professions. However, any resolution appears to depend on the outcome of deliberations about accounting and insurance supervision standards at an

international level. Nevertheless it does seem to us that clear and unambiguous reporting of the financial condition of life insurance companies, including informative reporting on risks and uncertainties of the business, would help to ensure that incipient problems are brought to light sufficiently early for appropriate action to be taken. Anything that the regulators and those responsible for Companies Acts can do to eliminate the present confusion would be welcome. Furthermore, the Committee believes that actuaries who advise directors should emphasise that the published financial reports should pay particular regard to explaining the different methods of presentation so that readers of these reports can properly understand their meaning and form a clear picture of the risks affecting the company.

The Committee's Assessment of Events
(A more technical description of events appears in Appendix 2)

1956

37. The Equitable introduced new with-profit pension contracts for the self-employed following fresh pension legislation in 1956. They were designed so that the policyholder could pay premiums of any amount (up to Inland Revenue limits) in any year and enter into pension at any age within a defined range. These contracts contained the premium-based guarantees described in paragraph 18 above. The legislation did not allow a policyholder to take cash instead of the annuity.

38. The Equitable did not regard these guarantees as requiring an addition to the provisions when they were first introduced, but it is also true that the valuation techniques used today were not then available. However, the failure to record at that time, within the valuation process, that they existed could be considered a contributor to the eventual problem. As we have already indicated in paragraph 18 above, the fact that single premiums up to the revenue maximum could be paid at any time on these guaranteed terms and that the pension could be taken at any age in a wide range meant that the policyholder had an open-ended claim against the Equitable. We do not know when the Equitable introduced a process for regularly taking note of such contingent liabilities. In the opinion of the Committee, it would have been prudent for the Equitable to have had such a process from the outset, even when those liabilities could be treated as unquantifiable or negligible. Such a process could have ensured that the Actuary (or Appointed Actuary once that role had been established) was reminded to consider whether the treatment was still appropriate.

39. A present day actuary should recognise that guarantees and flexibility can both be expensive, and should examine carefully the scenarios which could cause them to be used by some policyholders in a way which has the effect of reducing the returns available to the main body of policyholders. Where an actuary is giving an opinion on new contract terms, he or she should have full regard to the potential liability arising from whatever guarantees and flexibility are built into the terms of the policy. GN2 (at paragraph 1.7) mentions stochastic techniques as appropriate for such an assessment. We recommend that **the Guidance Notes refer specifically to open-ended guarantees and their potential impact on the financial condition of a life insurance company.**

1971 –1975

40. The regulatory role of the Appointed Actuary was created in 1973.

41. During the early seventies, interest rates rose substantially. The 1971 Finance Act made it possible for a policyholder to take part of the policy benefit in cash instead of as an annuity. Given

the investment conditions of the time, a policyholder would have been able to use that cash sum at whatever were the current market annuity rates to buy a larger annuity than that amount of cash would have provided under the contractual premium-based GAR. The Equitable therefore introduced a 'final bonus' for policyholders entering pension. This 'final bonus' was applied only to the part of the fund not surrendered for cash, and was to compensate for the contractual annuity (based on the GAR) being lower than the one that could be purchased in the market.

42. Thus in the early seventies, there existed a form of differential bonus. Policyholders who converted their whole policy accumulated fund into the contractual guaranteed annuity were given a higher bonus than that given to those opting to take a part in cash. In practice the calculation was shown as a final bonus on the whole accumulated fund, but the amount was less when some cash was taken.

43. In 1975, terminal bonus was introduced for all with-profit business, but the 'final bonus', now renamed the 'final annuity adjustment factor', continued to be added to the amount converted into an annuity at the contractual rate. The interest rate underlying the guaranteed annuity rates in new contracts was increased to 7%.

44. Policyholders were encouraged to make old series contracts paid-up and to apply future premiums to a new series contract. There was no improvement to the terms for existing pre-1975 contracts. No mechanism was introduced to reduce GARs if interest rates were to fall again.

45. The Committee does not know what thought the Equitable gave at the time terminal bonus was introduced to the possibility that investment conditions could change so substantially that no 'final annuity adjustment factor' could be added to the terminal bonus, or that the 'final annuity adjustment factor' might even be made effectively negative by reducing the terminal bonus for these policies.

46. The Appointed Actuary, or any actuary in a senior management position, should be aware that unexpected consequences can arise when irreversible decisions are made, especially if no limit is set on the time for which they are effective. The potential increase in the liability from policyholders adding to their policies should have caused actuaries at the Equitable to review the risks, and there might then have been some way of reducing the effect of the open-ended options against the company, perhaps by limiting in some way the open-ended nature of new policies.

1978

47. The form of the contract was radically altered when the 1978 Finance Act introduced Open Market Options (OMOs – see paragraph 18). The Equitable maintained the principal attractions for its policyholders of maximum flexibility in making contributions and in choosing the date for entering into pension, and the policies continued to provide a guaranteed minimum rate for an annuity purchased from the Equitable. As noted above, the interest rate underlying the GAR was set at 7% in 1975. It remained at this level until 1988.

48. The present form of contract reflects the radical changes made in 1978 by the Equitable as a result of the measures contained in the 1978 Finance Act. The contract now gave a guarantee to a minimum level of accumulated fund at retirement, expressed as a cash sum, most of which had to be converted into an annuity. The contract provided for a minimum guaranteed rate for conversion to specified types of annuity bought from the Equitable, the GAR. The 'final annuity adjustment factor bonus' was abandoned because a policyholder could achieve the same practical effect by exercising the OMO.

49. This change to the contract arguably provided another opportunity for the Equitable to appraise the overall risk that the company was running by majoring on contracts with potentially substantial open-ended guarantees. Although for each life insurance company a named actuary had been responsible for the actuarial investigations and valuations required under insurance company regulation since at least 1870, the role was only formally defined and clarified, acquiring the title of Appointed Actuary, in the insurance legislation of 1973. Starting in 1975, specific professional guidance for an Appointed Actuary has been steadily developed; both the aggregation of risk and the responsibilities of the Appointed Actuary were perhaps less well understood in 1978 than they are today.

50. A present day Appointed Actuary should be carrying out a risk appraisal for each new contract and periodically for the office overall. That is not to say that a new contract has to be riskless, or even profitable, provided that the aggregate of the risks is manageable within the total size of the funds and that any built in loss can be covered easily by free reserves (or shareholder funds). The Appointed Actuary has to certify that the premium rates for new contracts, on reasonable actuarial assumptions and allowing for the overall financial resources of the company, enable the company to meet its commitments.

51. We have seen an illustration issued to a prospective policyholder in 1985 (see Appendix 5). This is in a format that was probably in use between 1978 and 1988. The illustration shows the policyholder what the capital value of his contract might be, on certain assumptions about the reversionary and terminal bonus, at the point of entering into pension and purchasing an annuity. It also shows how much annuity could be purchased for that capital sum, first using the GAR, and then again using the Equitable's then current annuity rate. There is no suggestion that the size of that capital sum will differ according to whether the policyholder opts for the GAR or the current market annuity rate (Appendix 5 – see particularly the illustration of the fund and the pension, and notes 10 &11 on the reverse). We can well understand that policyholders who received such an illustration would believe that they had been seriously misled when they found out that, when their policy matured at some later date, the capital sum would be smaller (by virtue of a smaller terminal bonus) if they chose to take advantage of the GAR rather than the current market annuity rate. It is a management responsibility to ensure that information given to policyholders does not mislead them, and the Appointed Actuary must share in this responsibility. We recommend that **the Guidance Notes make plain that the Appointed Actuary should require that there is a process for reviewing communications to policyholders and potential policyholders. The process should embrace:**

- **(i) stated principles that the illustrations and other literature must reflect, and**
- **(ii) a consideration of how the policyholder who is not familiar with the constraints on a life insurance company might read them.**

1988

52. In 1988 new legislation introduced Personal Pension Policies which replaced the earlier policies which had conformed to the 1956 Act. The Equitable took the opportunity to redesign its terminal bonus system so that it could reflect more closely the investment return on the assets considered as supporting each policy.

53. The GAR was dropped from new Equitable policies and this may have been because policyholders' ability to use the OMO was regarded as sufficient protection against the insurer

trying to give the policyholder a poor annuity rate. We have also heard the view that this was no longer a requirement of the market.

54. The new contract was thus essentially different from its predecessor in that it lacked the underpinning of the rate for conversion of the policy benefit capital sum into an annuity, which had been provided previously by the GAR. The earlier policy contracts still had the open-ended commitment as well as the underpinning. The difference between new and old could have been marked by considering the new policy contracts as starting a new category of with-profit business with its own bonus rules (a 'new bonus series'). On declaration of the reversionary bonus at the end of each year, the bonus declared for the new policy contract could then have been greater than that for the old ones, in acknowledgement that the older ones enjoyed an additional benefit in the form of the GAR. The difference might have been very small, but an important principle would have been established. We consider that a new with-profit product should not be allowed to join a common bonus pool unless it can be demonstrated that there are unlikely to be circumstances when this could cause a problem. We recommend that **the Guidance Notes have more explicit references to the formulation of bonus recommendations to directors, maybe through a separate section. This section should include some wording that when a new with-profit product is introduced, the Appointed Actuary should consider whether it should join an existing common bonus pool.**

55. As an alternative to a new bonus series, the Appointed Actuary could have insisted that policyholders understood what would happen if the past guarantees became of real value because of a reduction in interest rates leading to reduced market annuity rates. The Equitable did not at that time start a new bonus series or alert the policyholders. We have been given to understand that the Equitable did consider the matter but assumed that the guarantees were unlikely to be invoked and that the policyholders had effectively and knowingly mandated to the directors absolute discretion over each individual terminal bonus addition.

56. If the decision to vary the terminal bonus according to whether or not the policyholder chose to take advantage of the GAR was taken when the new contract was introduced, this is not apparent from any of the documentation seen by the Committee. Early in each year a letter was sent out to policyholders with the bonus notices relating to the previous calendar year. We have obtained copies of the letters sent out in 1988, 1989 and 1990, and those sent out in 1993 and 1994 (see Appendix 6). The earlier group of letters explained the Equitable philosophy on bonus in increasing detail. They did provide a clear explanation of why the rate of reversionary bonus could move up or down over the medium term, and why the rate of terminal bonus could fluctuate quite rapidly. However, none of the letters gave any hint that there were any circumstances in which the rate of terminal bonus might differ according to a decision by the policyholder to take advantage of the GAR. As noted above, the illustration issued in 1985 gives the opposite impression.

57. If, in valuing the liabilities from 1988 on, the Appointed Actuary was resting on the assumption that any cost associated with the GARs could be recouped from the terminal bonus, an explicit provision could then have been created against the extreme case of the terminal bonus fluctuating to zero. We note that such a provision may have been de minimis and at that stage within other margins in the valuation basis. In its evidence to the Treasury Committee of the House of Commons, the Equitable has said that protection against this extreme case was the value to the relevant policyholders of their GARs. However, it must follow that if this was a contingent asset of the policyholders, it was also a contingent liability of the Equitable, however remote the contingency was thought to be.

58. We were told that in the mid 1980s the Equitable did consider introducing a similar pension contract with GARs, but based on an investment in units directly linked to the value of a portfolio of securities. Under such a unit-linked contract the policyholder takes the whole of the investment risk, which could be seen as a logical further step in the development of the Equitable bonus philosophy. The project was abandoned, and the Committee understands that this was because in this type of policy a provision would have had to be set up to provide for the cost of the GARs. Such a policy contains no terminal bonus provision so the cost of the GARs could not be met by adjusting the size of the terminal bonus awarded to the GAR policyholders.

59. Some of the alternative bonus strategies used by other life insurance companies, such as reducing all terminal bonus, or reducing terminal bonus for all policies with GARs, or reducing reversionary bonus in good time and then awarding extra terminal bonus to those who did not invoke the guarantee, would also have needed an explanation to policyholders. However, the Equitable, in common with some other companies, did not choose any of these strategies and our impression is that the Equitable saw no need to consider any alternatives to the strategy adopted.

60. We recommend that **the Guidance Notes require that, when advising the Board on policyholders' reasonable expectations or any successor concept under insurance regulations, the Appointed Actuary should ensure that other relevant strategies for meeting them are presented to the Board for discussion.**

1993

61. In October 1993, as a result of falling interest rates, the annuity rates in the GAR policy contracts began, for the first time, to exceed the Equitable's current annuity rates. This naturally was of concern to the Equitable, and no doubt to other life insurance companies which had policies guaranteeing annuity rates above those available in the market.

62. In its evidence to the Select Committee, the Equitable indicated that its Board confirmed a "differential final bonus practice to equalise the benefits in GAR and in cash form", thereby reducing in relative terms the terminal bonus for policyholders with GARs who opted to take advantage of them. The reasoning reflected the Equitable's philosophy about asset shares reflecting smoothed investment returns. The Equitable considered the terminal bonus as the means by which it could bring benefits in line with such asset shares. The Equitable therefore reduced the terminal bonus (which represented a part of the share of the profits of the company) for policyholders exercising the GAR. The size of the reduction was the amount necessary to ensure that the policy benefit could not purchase at the GAR an annuity greater than that which could be purchased with the full terminal bonus at current (lower) market annuity rates. The policies without GARs were awarded the full terminal bonus but the annuity rates applied were the lower market rates. As a result of its asset share and differential bonus approach, the Equitable conservatively estimated a cost of the liabilities arising from GARs in accordance with that approach and established a provision for that amount. That provision stood at £50m when the legal action began.

63. It seems that some of the policyholders who retired in the winter of 1993/94 may actually have been credited with a reduced terminal bonus, but as the Equitable's statement to the FSA reports that the company's experience had been that a very low proportion entered pension on the specified forms of annuity, it is unlikely that there were many. It is possible that these few may not have been clear that a reduction had been made; there seems to be no record of adverse comment at that time. The Equitable apparently felt that by repeatedly explaining to policyholders

that the proceeds of policies would be based on asset shares, the operation of a differential bonus had been understood and accepted.

64. We understand that the Equitable was preparing a communication explaining the policy of selectively reducing the terminal bonus to go out with the bonus notices in the spring of 1994. When market annuity rates rose above the GAR again, the Equitable decided not to issue the communication. If this communication had been sent out, it is possible that the objections from policyholders would have arisen at that time and there would still have been time to consider some alternative strategies. We have seen the notes sent out with the bonus notices for 1994 to 1997 (Appendix 7) and although those for 1995 and 1996 state that the terminal bonus for policies with GARs may be reduced to take account of the cost of providing the guarantee, there is no suggestion of differentiating terminal bonus according to whether or not the option of using the guarantee is exercised. Interestingly, in all four years the notes state that the terminal bonus might be reduced if the OMO is exercised.

65. With hindsight, it is clear that it would have been better if the Equitable had publicised its intention to adjust the size of the terminal bonus awarded to those policyholders who decided to take advantage of the GAR. The Committee does not know the circumstances behind the decision not to issue the communication.

66. It is not inconceivable that in a situation of that kind the Appointed Actuary and the management would have had differing views. The management might have seen it as in the company's interests that policyholders were not unnecessarily disturbed. The Appointed Actuary might have seen a need to ensure that policyholders were kept fully informed and might even have seen the situation as one which would justify recourse to the 'whistle-blowing' action provided for the Appointed Actuary in the regulatory legislation. However, in a situation where the roles of Appointed Actuary and Chief Executive are combined, such action would have been unlikely. We do not know whether events would have been different at the Equitable had the roles of Appointed Actuary and Chief Executive been kept separate.

67. Whatever the particular facts of the Equitable situation may have been, the Committee finds it hard to understand how the important role assigned to the Appointed Actuary can be made to work in the way intended if the holder of that post is also the Chief Executive, or indeed any other role with the potential for a conflict of interest.

68. Although in today’s environment the problem is unlikely to arise, the Committee considers that, in the absence of any legislative provision to the same effect, **the Guidance Notes should require that an actuary resists holding the dual role of Chief Executive and Appointed Actuary or any role which compromises his or her ability to fulfil the duties of the Appointed Actuary.**

1998

69. Interest rates had fallen below 7% between November 1993 and February 1994, but it was not until the middle of 1997 that they fell again to a level which caused the current annuity rates to be lower than the GARs. For the 1997 bonus, payable in 1998, the Equitable announced that it would operate the differential terminal bonus, on the 1993 pattern, so that any policyholder seeking to take advantage of the GAR would be awarded only a reduced terminal bonus. As noted above, the Equitable considered this to be the correct way of maintaining equity between those with-profit policyholders whose contracts provided for a GAR and those whose policies did not. The Equitable has argued that the GAR still provided some benefit to those policyholders whose contracts contained it in the particular circumstances of the directors deciding upon a nil terminal

bonus and of market annuity rates still being low. In such circumstances policyholders whose contracts provided for GARs would, if they chose to take advantage of the GARs, receive a higher annuity than policyholders whose contracts provided only for market annuity rates. Thus the Equitable could maintain that the GAR still provided a meaningful benefit not available to other policyholders whose contracts did not contain it.

70. However, the 1985 illustration of benefits cited above (Appendix 5) would, by itself, lead the ordinary recipient of such an illustration to assume that any available terminal bonus would not be reduced if he or she chose to take advantage of the GAR. It was the decision to operate the differential reduction of terminal bonus that caused the dissatisfaction amongst the policyholders with GARs. The path from this dissatisfaction to the House of Lords decision that ultimately led to the Equitable's closure to new business has been set out elsewhere and is not strictly relevant to this Inquiry.

71. As interest rates fell in the late 1990s, the proper value to place on GARs began to receive attention within the profession. A report from an Annuity Guarantee Working Party of the Faculty and Institute of Actuaries was published in November 1997 (see Appendix 9) and a position paper giving answers to questions that might be raised on the subject was prepared in March 1999 (see Appendix 9).

72. By this time the regulators had become concerned. In June 1998 the Government Actuary's Department (GAD) sought information from life insurance companies on whether they had GARs and what steps they had taken to establish methodologies for setting up prudential provisions as required by the regulations. The Government Actuary then wrote to Appointed Actuaries on 13 January 1999 about the conservative statutory provision required for solvency reporting (see Appendix 9). The letter sets out the "application of the existing reserving requirements in respect of contracts containing a guaranteed annuity". The letter includes (paragraph 7) the words "Where the levels of terminal bonus are to be adjusted with the aim of bringing the value of the guaranteed annuity option closer to the value of the alternative benefits" which suggests that the regulators accepted the position that the Equitable maintained, namely that the effect of the guarantee could be neutralised. However this paragraph also states that "the company's discretion in setting the value of terminal bonus applied to the alternative benefit is limited as a result of the existence of the guaranteed annuity". Therefore it is not clear to us whether the Government Actuary had in mind setting a differential terminal bonus individually for each policyholder according to the choice made by that policyholder about taking advantage of the GAR, or only for the whole class of policyholders whose contracts contained a GAR option, whether or not the policyholder decided to take advantage of it.

73. The Government Actuary's letter also contains passages stating the assumptions about the proportion of policyholders likely to exercise their GAR options which companies should make when computing the statutory provisions for their statutory returns (a definition of statutory provisions appears in Appendix 3). The required assumption was that almost all, i.e. 90%, of GAR policyholders would exercise their GAR options. This proportion was much larger than any indicated by past experience and any which the Equitable believed would apply in future. In this, the Equitable was supported by a reinsurer prepared to underwrite the risk of the number of GARs being taken up being greater than the Equitable's own estimate which was a conservative number based on past experience. The reinsurance was, in effect, an asset to set against the Equitable's statutory liabilities and was a necessary arrangement if the Equitable was to continue to be allowed to write new business.

74. This reinsurance arrangement was based on the Equitable's assumption about the take-up of the GAR which was invalidated by the House of Lords ruling that it was unlawful for the company to award to any policyholder whose contract provided for a GAR a lower level of terminal bonus than was awarded to policyholders whose contracts did not provide for a GAR (commonly called 'ring-fencing'). We believe that where a life insurance company has a major asset which is dependent on a significant assumption, particular care should be given as to how that assumption is reported in its financial statements and its returns to its regulators. If the uncertainty cannot be quantified as a liability, then directors and the relevant actuary should consider whether this dependency should be reflected in a statement on significant or fundamental uncertainty.

75. By 1998, when policyholders, faced by market annuity rates below the guaranteed rates, were wanting to take advantage of the GAR and when many policyholders were protesting at the differentially reduced level of terminal bonus awarded to them, it may have been too late to take avoiding action. As noted earlier, we are not aware that the Appointed Actuary and the Equitable management considered any alternative solution to the differential adjustment of terminal bonus. We recommend that **the Guidance Notes require that in the fields where the Appointed Actuary is responsible for making recommendations to the Board, the reasonable alternative courses of action with their advantages and disadvantages should also be set out.**

The House of Lords Judgment

76. When certain policyholders began to question the differential bonus issue through the Pensions Ombudsman, the Equitable acknowledged that its position was wholly dependent on its ability to determine, policy by policy, the amount of terminal bonus to be awarded at the point of entering into pension and purchasing an annuity. With the apparent acquiescence of the regulators, and the legal advice it was receiving, the Equitable must have considered its position as lawful and expected to have that view confirmed in the courts.

77. The judgment in the House of Lords did not support the Equitable's interpretation of the powers of discretion available to directors in the Articles of Association. The reinsurance agreement could no longer stand following the House of Lords decision and was replaced by one that gave less protection. The Equitable therefore had to set aside sufficient provisions to cover the possibility that a high proportion of policyholders would take advantage of the GARs, and that many of those with contracts providing for the open-ended option to invest further sums qualifying for GARs might exercise that option to increase their investment. Moreover the additional judgment on ring-fencing, which prevented the Equitable giving all GAR policies a lower terminal bonus than non-GAR policies, increased the cost to the extent that no reversionary bonus could be allotted to any policies in respect of the first seven months of 2000. It was the impact of this decision that changed the situation from one which the Equitable might have been able to handle to one that caused the company to try to find a purchaser and, when that failed, to stop writing new business.

Guidance Notes

78. The Guidance Notes issued by the Faculty and Institute are developed over time and are modified periodically as experience is gained or the regulatory background changes. Even those that were first written many years ago appear to be reasonably comprehensive, although there could be scope for clearer wording than some phrases, such as 'having regard to'. When considering professional guidance, we have found little relevant to guidance in this sequence of events at the Equitable and relating to GARs that is not already covered in principle by the existing Guidance

Notes, mainly by GN1, although in our opinion a number of more detailed alterations and amendments should be considered.

79. A table showing how the recommendations in this report line up with past and current guidance is given in Appendix 8.

80. The comments on the Guidance Notes made by the senior actuaries invited to give their views have given a range of opinions and these are summarised in Appendix 4. One school would like guidance to be 'rolled back' to a plain statement of principles, worried that detail obscures those principles and that detail can never cover all future scenarios. Others would like the guidance to be thorough and, in the first instance, would add 'and guaranteed annuity rates' where appropriate. A number thought that the present guidance is adequate or made no comment on guidance.

81. Whilst the coverage is satisfactory, the Committee recommends that **the wording of GN1 and GN8 be reviewed to ensure that they are expressed in a clearer and more user-friendly manner.**

Conclusions

82. It has been suggested to us that if any one of a number of the decisions made over a period of forty-four years had been different, there would have been no need for the Equitable to close the fund to new business in December 2000. The Equitable was undoubtedly successful and, until recently, enjoyed the support of loyal and satisfied policyholders. The logic of its unusual bonus philosophy is clear and did not appear, at the time, to have contravened regulations. But it received only limited support from other actuaries, and other mutuals did not follow the Equitable's lead and abandon free reserves.

83. The Equitable went further than many other life insurance companies to provide the most customer friendly pension product in the market. Its natural catchment population was the self-employed and those with variable earnings, and it saw a need to provide a pension product that would allow for the variations over the years in earnings of these people and for late decisions on retirement. A very early decision was to provide open-ended guarantees that allowed additions to policies on original terms and without limit. Once given, little can be done to alter guarantees of this nature. The Equitable may not have been alone in granting such guarantees; here and elsewhere the risk may have been identified, considered acceptable and properly reported to the board. However, at the time the risk was accepted, the Equitable may not have recognised the growth potential of that sort of business and the possibility that it would constitute so large a proportion of its total business.

84. The origin of the GAR option to convert a cash fund into a pre-determined amount of annuity emerged in 1978 from a complex history. Once in place, it was continued as an assistance to support sales, giving the impression that it was of value to the policyholder, even though the annual published valuations of the liabilities placed no explicit value on it. Other life insurance companies followed the Equitable in continuing to grant GARs and there is a suggestion that they also took the view that the value of the GARs was so low that there was no need to set up an explicit provision.

85. A possible reason for the difference between the Equitable's handling of GARs and that adopted by some other life insurers may have been the existence of an open-ended guarantee on some of its most popular products. Some other insurers promised only to maintain the guarantee for the contributions made before a certain date or during the first few years from taking out the policy. For the group schemes written by other life insurance companies the guarantee might again be given only on contributions before a given date, or perhaps only for new entrants before such a date.

86. Another feature of the Equitable was that the business with GARs formed a very substantial part of the total book of liabilities. For most other life insurance companies the proportion was more modest, and the cost of honouring guarantees could be expected to be small compared with the free reserves – especially if the company maintained an Estate.

87. One decision that might have been criticised at the time it was made was to allow a new product with a different benefit profile to enter the bonus pool without any provision for differentiating the bonus. It would have been better if in 1988 the new product had included explicit provision for the granting of a slightly higher terminal bonus than would be allocated to the old one to compensate for the removal of the guaranteed annuity rate. The Guidance Notes do not cover this specific point, although it might be inferred from GN1 (3.4) where it points to the legislation including the need to pay ‘due regard to the interests of policyholders and potential policyholders’.

88. We have no information on what discussions on policyholders' reasonable expectations took place within the Equitable. The Equitable’s letters to policyholders seem to suggest that a ‘full distribution of asset share’ was considered sufficient to fulfil them. It seems likely that most people in the company were wholly persuaded that the Articles of Association (article 65) gave directors absolute discretion in allocating terminal bonus, and that this allowed the terminal bonus to be adjusted so that no policyholder got more than his or her asset share. However, the Articles of Association were written before the advent of terminal bonus and would have been drafted with just reversionary bonus in mind. In this context the wide discretion would have allowed the directors to determine the level of reversionary bonus each year without being constrained by precedent, and to allocate different levels for policies of different classes and different periods since inception, but it seems unlikely that an even wider discretion, to alter the level of bonus for an individual policy, was then contemplated. Nothing seen by us would have caused the policyholders to understand, at least before 1993 and probably before 1998, that the Equitable was assuming that it could adjust the terminal bonus according to decisions made by policyholders about taking advantage of the GAR options in their contracts. The Appointed Actuary is responsible for advising the Board on the PRE but it is difficult to see how the Appointed Actuary, whether or not that role was combined with that of Chief Executive, could have persuaded the Board to change its view once the Board had the support of legal advice about the extent of directors’ powers of discretion. He could have discussed the problem with the Regulator and may have done so, but it is also possible that the Appointed Actuary was himself persuaded by the advice received.

89. On the question of whether the guidance was adequate, we conclude that most of the matters we have identified for which guidance was relevant were covered by the Guidance Notes in some form, even if the wording on some points was general rather than specific. This sense of implicit rather than explicit guidance applies particularly to the considerations surrounding the operation of a bonus system for with-profit policies and the desirability or otherwise of having more than one bonus pool (paragraph 54). Another example would be the presentation by the Appointed Actuary of the alternatives to his or her main recommendations so that the management and board can

have a fully informed discussion (paragraph 60 and paragraph 75). We have recommended that in the light of our findings the wording of the Guidance Notes be reviewed, but we consider that it is for the professional bodies to decide whether any strengthening should be by the addition of specific wording or by making the principles clearer.

90. We have not found evidence to suggest that any Appointed Actuary of the Equitable failed to take account of the guidance that was current at the time the various decisions were made. We do not know what conclusions any Appointed Actuary at the Equitable reached when considering how the published Guidance Notes affected his decisions, nor what advice he gave to the management or the Board. We also cannot tell whether the decisions of the Board were in accordance with that advice. We have seen no evidence to indicate that any Appointed Actuary at the Equitable was at any time so concerned about the nature of those decisions that he felt it necessary to 'blow the whistle' to the regulator. Our conclusion is that it was an accumulation and combination of decisions, actions and communications, over a very long period and involving not only the Appointed Actuary but also the management and the Board of Directors, that made the Equitable so vulnerable to the impact of adverse events.

91. There are two clear lessons, or more properly reminders, for actuaries and perhaps for others concerned with life assurance companies and other risk-bearing enterprises. The first, that it is not only individual risks that have to be taken into account but the chance of many of these risks arising at the same time and compounding the liability (paragraphs 49-50). The second, that it is the cumulative and compounding effect of these risks that must be assessed in the context of the available unallocated capital (paragraphs 22-24).