

Equitable Life Assurance Society
Things you should have known about your annuity,
but didn't know enough to ask!

3.1) Introductions

One of the obvious problems facing all annuitants is understanding what they are being offered by their supplier, in this case the Equitable life Assurance Society (ELAS)

Just before the point of contract annuitants will have received (or should have received) a document that contained amongst other information the following

Male aged over NN years (born 1st January 19NN)

Retirement date 28 February 19NN

Purchase price £nnn,nnn.pp

The gross amount of each annuity payment will comprise two parts-the basic payment guaranteed in the policy and, after the first year, an enhancement in the form of bonus. This illustration is based on the guaranteed basic payments being arranged so that if the future overall rate of return increases the guaranteed benefits by 7.00 %p.a., the gross annuity will be level throughout.

Initial gross annuity £nnn.pp per month

Please note that the payments from a with-profits annuity can go down as well as up.

This illustration is on a with-profits basis, and uses the same rates of return as other insurance companies' illustrations, but uses the Society's own charges. The projected figures are only examples, none is guaranteed and they do not represent the minimum or maximum amounts. The eventual benefits will depend on how the investments perform and may be more or less than those shown. Do not forget that inflation would reduce what you could buy in the future with the benefits arising.

Benefits on survival

The annuity payments, after the first year, will depend on the level of bonuses applying in the future.

	Guaranteed basic payments	Projected gross payments if future rate of return is		
		6% p.a.	9% p.a.	12% p.a.
After 5 years	£645	£843	£970	£1110
After 10 years	£460	£786	£1040	£1360
After 15 years	£328	£732	£1110	£1680
After 20 years	£233	£683	£1190	£2060
After 25 years	£166	£636	£1280	£2530
After 30 years	£118	£593	£1370	£3120

The annuity payments shown above are amounts per month.

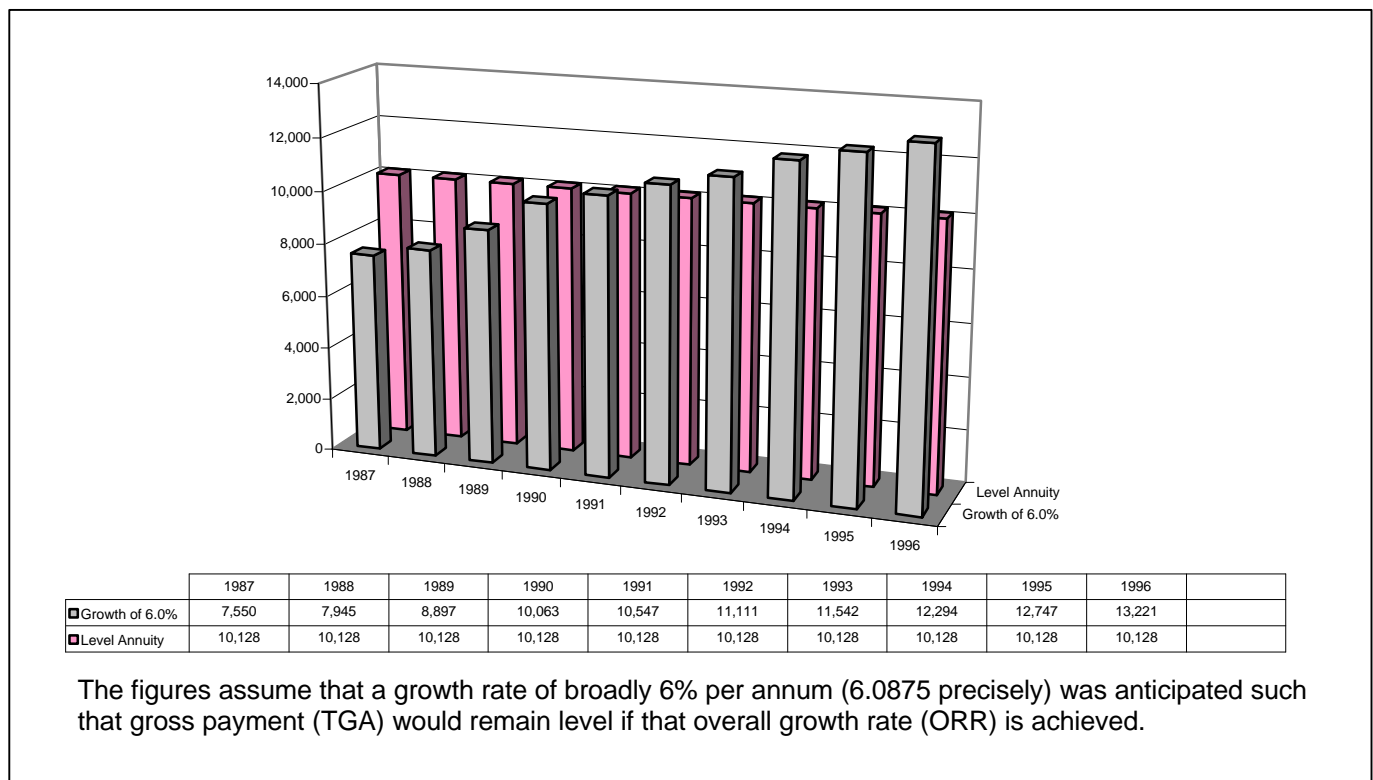
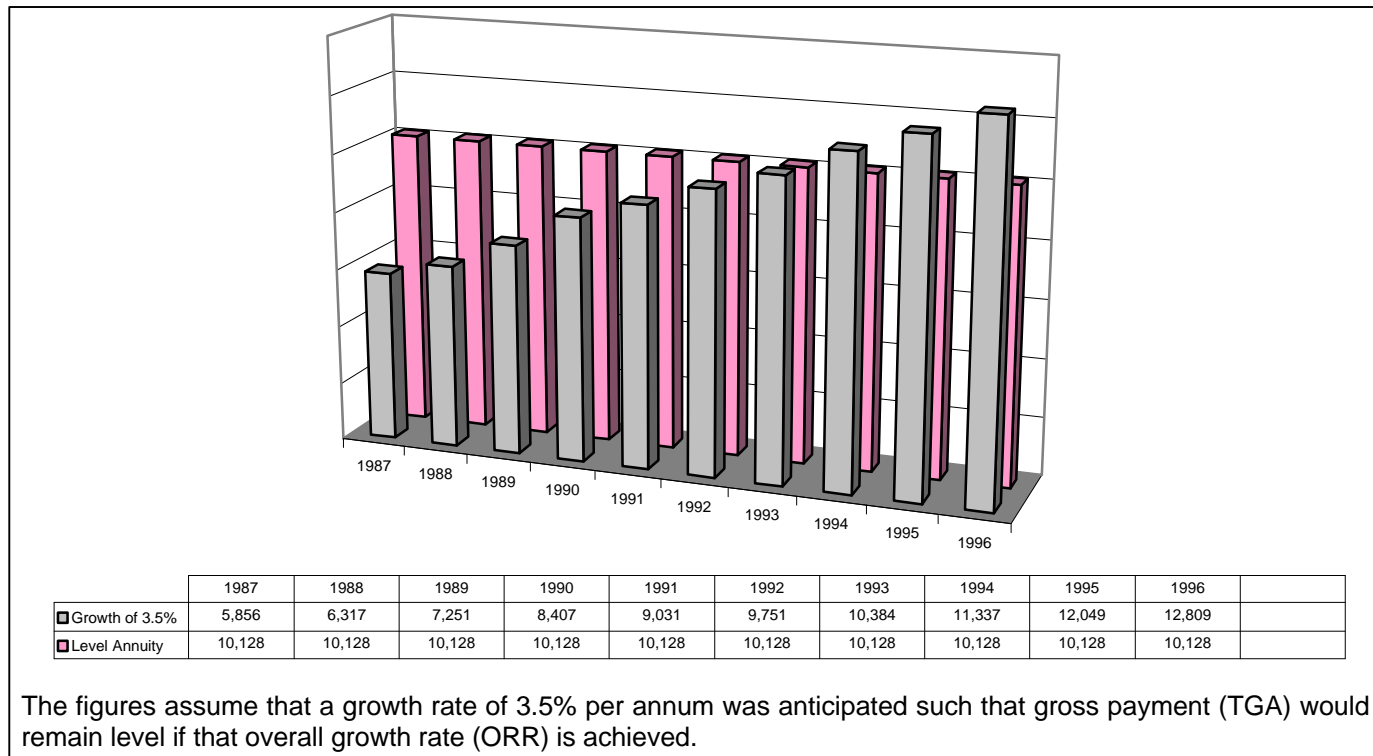
The annuity will be payable by monthly instalments, the first falling due on the first day of the month following immediately after purchase and the last on the due date immediately preceding the death of the annuitant. In the event of the death of the annuitant before 120 monthly instalments have been paid the remainder of those instalments would continue to be paid on the monthly due dates.

Post 1987, the Society introduced With-Profits Annuities and at that time offered them with a Guaranteed Interest Rate (GIR) of 3.5%. This must have been extremely attractive to potential policyholders though in fact it was not necessarily in their best interest.

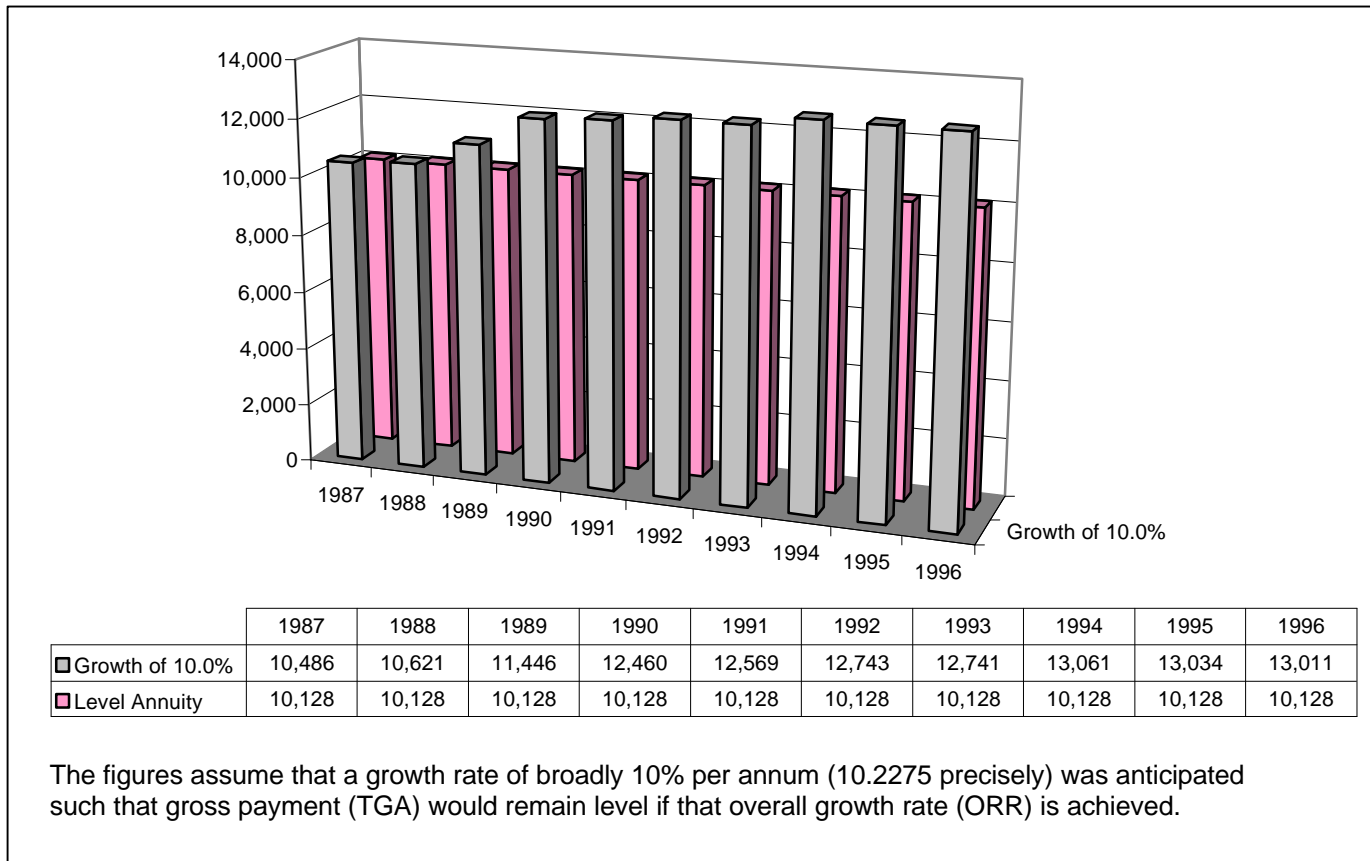
Basic Guaranteed Annuity (BGA); Declared Bonus Annuity (DBA); Total Guaranteed Annuity for the year (NGA); Final Bonus Annuity (FBA); Total Gross Annuity (TGA); Anticipated Bonus Rate (ABR); Overall Rate of Return (ORR); Declared Bonus Rate (DBR); Total Return for a Level Annuity (TRL)

Post 1996, this option was withdrawn and With-Profits Annuities were only offered without this guarantee. At the same time the Society decided to make changes to the GIR policies that have only become apparent recently as this study has developed.

In addition, prospective annuitants will have received a brochure from the Society containing generalised illustrations of the historic performance of a With-Profits Annuity with different growth rates and which contained diagrams similar to the following:



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)



These charts have been copied from a document issued in early 1997 and thus these historic figures would have been based on GIR policies. As illustrated in the last example with the 'Growth Rate' of 10%, it is important to note that at a by 1995 and subsequently the Total Gross Annuity (TGA) was already beginning to decline as rates fell. It is at this time that the Society replaced the GIR policies with non-GIR policies, that is, policies without the Guaranteed Interest Rate (GIR).

The higher the ABR (TRL) that is chosen by the annuitant, the higher the starting point of the annuity, which is very attractive. Less attractive and not overly emphasised is this increases the exposure to a reduction in the TGA. if the Society reduces the ORR as a consequence of any lowering in the growth of the economy as it moves through its cycle.

These trends are difficult to predict and way beyond the capability of the average pensioner. It seems that the risks that attach themselves to such a type of investment, which is what a With-Profits Annuity is in reality, were never clearly explained by the Society's representatives or by the Society itself. It is a matter of debate if such an investment were a suitable medium for what must surely should have been a safe and secure place to generate income for a group of people whose opportunity to recover in the event of a financial disaster, whatever the cause, is severely limited by their age.

Looking at the figures and the charts, the annuitant might reasonably conclude that an ABR of approximately 7.0% would give a combination of a high starting annuity and some potential for growth. The decision would be neither right nor wrong and may well depend on factors that are personal to the annuitant.

For example, if the annuitants were expecting future income from other sources, other pensions, returns on investments, legacies, etc, then a decision to take a higher annuity now to gain the immediate benefits, with the inevitable risk of a lower annuity in the future, with a plan to use the income from other sources in the future to maintain the standard of living might be a perfectly sensible decision.

Alternatively, if the annuitant did not need income in the short term, maybe because there was an opportunity for earned income in the immediate future, then maybe a low annuity now might be a better choice.

What was not explained, and arguably has never been explained, is how the annuity system from ELAS actually works. The Society has been remarkably coy in supplying the information, especially with respect to the Total Gross Annuity (TGA), partly, in fairness, because the method used by the Society is very, very complex to the point of obfuscation, but partly because that is how the Society appears to relate to its annuitants. Quite why the Society chose its method of computing the TGA is not evident and to date no explanation has been offered that makes sense, since there are easier less complex methods that give results that parallel those of the Society. This is particularly significant since, the method of deriving the TGA in any one year is the one most easily used by the Society to increase or decrease the annuity actually paid.

3.2) The Equitable Life Annuity

Regrettably in order to understand what follows, it is necessary to explain how the annuity system of the Society works. There is a more detailed analysis of this aspect in Section 3 but the following is intended to be enough for this section

The Equitable Life Assurance Society (ELAS) produces With-Profits Annuity - Annual Statements every year for each annuitant and which in general contain the following information:

- The Renewal Date
- Basic Guaranteed Annuity (BGA)
- Declared Bonus Annuity (DBA)
- Final Bonus Annuity (FBA)
- Total Gross Annuity (TGA)

Historically, the Society also produced another document and somewhat confusingly called the Bonus Declaration for the Year Ending 31 December 19NN, which contained references, amongst other things, to:

- Anticipated Bonus Rate (ABR)
- Overall Rate of Return (ORR)
- Declared Bonus Rate (DBR)

There is one other abbreviation that must be introduced which is:

- The Total Return for a Level Annuity (TRL)

N.B. In the footnote to each page is a summary of all the abbreviations used in each section as an aid to understanding.

Until July, 1996, With-Profits Annuity policies contained a Guaranteed Interest Rate (GIR) of normally 3.5% per annum which was to be allotted BEFORE any policy bonus. The GIR is NOT a bonus. It is a contractual entitlement similar in principle to the former GAR. All With-Profits Annuity policies since mid-1996 are non-GIR.

For GIR annuities the TRL is the $ABR \times 1.035$ and for non-GIR annuities the TRL is the same as the ABR.

At the outset of an annuity, the annuitant transfers a sum of money, the **consideration**, in exchange for a regular payment, the **annuity**. The annuitant agrees with the Society in advance an anticipated rate of return (ABR).

Very simply the annuity is calculated using a combination of the various interest rates, ABR, ORR, etc from the initial annuity value which is determined by the amount of consideration money and the rates for conventional annuities relevant to the policyholder. Each year the Society computes new values for each element of the annuity using two separate arithmetic series by using the ABR, TRL, DBR & ORR in different ways, so that the series in theory diverge.

- i) One series computes the BGA and DBA
- ii) The other series computes the TGA.

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)

The BGA and DBA are “guaranteed” under the terms of the annuity, which is not quite what it seems, not least because these two elements of a With-Profits Annuity do not give a constant annual guarantee. The BGA is a reducing guarantee, which is at the rate of the ABR, whereas the DBA can increase, remain level or increase depending on the relationship between the ABR chosen by the annuitant and the DBR for each year set by the Society.

The Total Gross Annuity (TGA) is increased each year by the effect of the ORR and decreased each year by the effect of the TRL. Thus if the ORR is greater than the TRL then the annuity will increase and if the ORR is less than the TRL then the annuity will decrease.

The FBA is the difference between the TGA and the sum of the BGA and DBA. However, the FBA is not guaranteed at all and can be withdrawn by the Society at any time.

In discussions with many WPAs, it is clear that they recognised that the Total Gross Annuity (TGA) might go down in ‘bad years’ and then it would recover in ‘good years’ and that the Society would do its best to even out these variations to provide a constant level of income. However, when the decision to make the 20% reduction was implemented, it was immediately clear for the very first time, not only how the FBA was derived, but that it was added at the discretion of the Society and, much more importantly, it could be removed in its entirety by the Society, also at its discretion with a devastating consequence on the TGA and the incomes and lifestyles of the With-Profits Annuitants.

3.3) How the ELAS annuity works!

The size of the annuity is calculated using a combination of the various interest rates, ABR, ORR, etc from the initial annuity value which is determined by the amount of consideration money and the rates for conventional annuities relevant to the policyholder. As is obvious from the earlier charts, the annuitant then chooses an Anticipated Bonus Rate (ABR) that meets his/ her requirements, partially advised by the Society’s representative.

What is not made clear is that within that broad constraint, there are other rules that apply and that affect the future income of the annuitant.

The table below shows a typical set of results over a period of time reflecting the basic data. Whilst it is NOT an exact copy of an annuitant’s data, it is close enough to be used for this report. The TRL for a non-GIR annuity is the same as the ABR. The GIR annuity is NOT illustrated which with this type of annuity the TRL is increased by 3.5%. so in this chart the TRL would be as follows $1.07 * 1.035 = 1.10745$.

As mentioned above, there are two arithmetic series that “control” the total size of the annuity payments and the relationship between the various elements that make up the Total Gross Annuity (TGA)

- A) One series computes the BGA and DBA
- B) The other series computes the TGA.

Year Commencing		1/3/3997	1/3/3998	1/3/3999	1/3/2000	1/3/2001	1/3/2002	1/3/2003
Basic Guaranteed Annuity	BGA	10,000	9,346	8,734	8,163	7,629	7,130	6,663
Declared Bonus Annuity	DBA	0	509	1,075	1,463	1,817	2,139	1,999
Total Guaranteed Annuity for year	NGA	10,000	9,855	9,809	9,626	9,446	9,269	8,663
New Declared Bonus Annuity	NBA	545	641	490	481	472	0	0
Final Bonus Annuity	FBA	0	706	1,048	1,738	2,131	2,307	2,557
TOTAL GROSS ANNUITY	TGA	10,000	10,561	10,857	11,364	11,577	11,577	11,220
%Overall Rate of Return on fund	ORR	13.00	10.00	12.00	9.00	7.00	3.70	0.00
% Declared Bonus Rate	DBR	6.50	6.50	5.00	5.00	5.00	0.00	0.00
% Anticipated Bonus Rate	ABR	1.0700						
% Total return for level annuity	TRL	1.0700						

3.3.1) Overall Rate of Return (ORR) in relation to the Total Return for a Level Annuity (TRL) The logic that applies is as follows:

1. If the ORR equals the TRL then the TGA remains constant or level
2. If the ORR is greater than the TRL then the TGA will increase
3. If the ORR is less than the TRL then the TGA will decrease

Since the TRL is derived directly from the ABR, it follows that when choosing your ABR, understanding or at worst guessing what might happen in the future will influence your decision. The **ORR** is under the complete control of the Society and whilst in theory it reflects the underlying performance of the With-Profits Fund, it lies within the power of the Society to inflate or deflate the fund to reflect its perceived current and future liabilities and/ or its business objectives, none of which need be congruent with the needs of the WPAs.

One of the consequences of the GIR type annuities with the increased the TRL is that the guaranteed element of the annuity was actually lower than it might otherwise have been, had the “guarantee” not been offered. It is now known that it is the un-guaranteed element that can be removed at will which poses the question, ‘what benefits the “guarantee” actually offers to the annuitant?’ It is also obvious from the third chart above that as the ORR achieved by the Society began to decline towards the middle to late 1990s, then the TGA began to decline also. It was at this time that the GIR annuity type was withdrawn.

3.3.2) The Anticipated Bonus Rate (ABR) in relation to the Declared Bonus Rate (DBR). This is slightly more complicated in the sense that this relationship determines what part of the annuity increases or decreases relative to a norm. The model above illustrates a typical annuity started in 1997 and which will be used as the benchmark.

The logic that applies is as follows:

1. If the ABR is equal to the DBR, then relative to the benchmark, the NGA increases and the FBA decreases.
2. If the ABR is greater than the DBR, then relative to the benchmark, the NGA decreases and the FBA increases.
3. If the ABR is less than the DBR, then relative to the benchmark, the NGA increases and the FBA decreases.

Whatever the relationship between the ABR and DBR, the Total Gross Annuity (TGA), that is the money actually paid to the annuitant, is NOT changed.

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)

For some reason, not so far explained by the Society, in the period from 1997 onwards when the GIR and non-GIR policies overlapped, the DBR for the GIR annuitants was set at 3.5% below the DBR for the non GIR annuitants. (Except when the DBR was set to zero.) Why this was done is not clear, as it had no effect on the TGA though of course the FBA was increased and the NGA decreased.

It follows that when choosing your ABR, understanding or at worst guessing what might happen in the future will influence your decision. The **DBR** is under the complete control of the Society and whilst in theory it reflects the underlying performance of the With-Profits Fund, it lies within the power of the Society to determine what the DBR for any year will be, bearing in mind its own objectives which, as before, need not be congruent with the needs of the WPAs.

For example, in the last 4 years the Society has declared the DBR to be zero. That of course may be entirely justified, but interestingly the effect, as is clear from the above logic, is that in these circumstances the NGA is reduced and the FBA is increased. (The second logic statement.) The FBA is not protected and can be removed by the Society at any time.

There is conflict between the Declared Bonus Rate (DBR) chosen each year by the Society and the Anticipated Bonus Rate (ABR). For the annuitant it is better to have a low ABR and a high DBR. For the Society it is the other way around. This is because when the ABR is zero, the system pushes the money into the DBA element of the annuity, which is protected, and when the DBR is zero, the system pushes money into the Final Bonus Annuity, which is not.

3.3.3 The Interim Rate and the Overall rate of Return (ORR)

The Society uses a concept known as the Interim Rate. In any one year, the Society announces an Interim Rate, which the Society then uses to forecast and calculate the annuity payment, though the actual Overall Rate of Return, which is usually different by one or two percentage points, and announced later during the first quarter of the year is also used to calculate the annuity payment.

The Society then goes through an adjustment process, which is so far unexplained and in truth seems inexplicable but it is based on the relationship between the start date of the annuity, the interim and 'real' rates and the date when the Society changes from the one to the other. The Society has supplied several documents to annuitants which are supposed to explain how the annuities are calculated using this so called Interim Rate They are inconsistent with each other and in any event, based on the interpretation used in the document, neither gives more accurate results than the computer model nor can they be applied consistently across all the annuities, without manual intervention. Explanations have been requested from the Society but none as yet has been forthcoming.

What is puzzling is why the Society chose this method of computation. The interim rate is useful for forecasting the likely payments but is not necessary to compute the annuity payment. The argument presented by the Society, which is that they cannot compute the ORR for 1st January each year, is perfectly rational, so given the Society's fiscal year is January to December, why not choose a renewal date of 1st of April and then apply the ORR for the next 12 months? This is the procedure the Society has used to introduce the 20% reduction, which was applied from 1st February 2003 and comes into effect as annuities are renewed in the following 12 months.

Alternatively, in a business that in normal circumstances is as relatively stable as a life company, the end of year financial position is, or should be, well known in advance. There is no obvious reason why the ORR could not be set by December based on the interim accounts and then adjusted the next fiscal year to keep the payments in line with the actual results of the Society. This point is brought into focus by the way the Interim Rate and ORR are used. If it is necessary to achieve an exact ORR, the ONLY logical explanation for a delay, then why is the ORR always set to a whole number (10%, 13%) and never 10.12345%? The supposed gain in accuracy from having a set of finalised accounts is lost in the rounding process!

3.3.4 The Overall rate of Return (ORR)

The annuity paid each year is determined solely by the relationship between the TRL and the ORR (see 3.3.3 above). What therefore is the function of all the other elements of the annuity? Why is it necessary to have a Basic

Guaranteed Annuity (BGA), a Declared Bonus Annuity (DBA) and a Final Bonus Annuity (FBA)? Why is it necessary to have a “Guaranteed” and “non-Guaranteed” elements in the annuity at all?

There does not appear to be an obvious reason. If the results are poor, then the society can reduce the ORR and the annuity declines or if results are good, then the annuity increases. What could be easier?

There is one possible explanation. It is very convenient to have a large amount of money allocated in theory for future payments to annuitants that can be removed at a stroke. As this is in fact what has happened, is this a possible explanation for the unnecessarily complex and, so far as is known, unique structure of the With-Profits Annuity of the Society?

3.3.5) The Compromise Deal

The Compromise Deal was proposed by the Society as the way forward to resolve the outstanding difficulties facing it and by implication and amongst others, the WPAs. As an inducement to accept the deal, the WPAs were offered 4% uplift on the BGA and DBA elements of their annuities, (0.5% for GIRs) and 2.5% uplift on the TGA element for all WPAs irrespective of type. (GIR or non-GIR). This took place in the fiscal year 1st April 2002 & 30th March 2003.

1. Increasing the BGA or DBA only transfer money from the FBA to these elements. The Total Gross Annuity is **NOT** affected
2. Significantly reducing the ORR at the same time of the 2.5% uplift cancels the effect of the uplift. Of course, the reason the Society chose to make the reduction in the ORR at the same time may reflect other conditions that are so far neither known nor explained.

The 4% uplift (0.5%) definitely occurred and by implication so did the 2.5% uplift, though it is not possible to isolate the uplift from the other reductions taking place at the same time.

3.4) Summary

The method used by the Society for deriving the inter-relationships between the various elements of the annuity is extremely subtle and quite beyond everyone who has not done (or might be capable of doing) this type of analysis. And even then it is only obvious with hindsight and gained by comparing annuities, something that was not feasible in the early 1990's before the widespread availability of the Internet.

It was surely not unreasonable to expect that the documentation included all the information that needed to be known. But as this research project and analysis demonstrates, it was not. The information that was necessary was simply not presented. It is doubtful if the sales force knew, could have known or even understood what they were offering.

In summary:

1. The Burgess Hodgson report made clear that by the late 80's & early 90's, the Society was in deep financial trouble. At that time, the Society dropped the GAR's as presumably the Society began to realise that they were not financially supportable in the long term.
2. The Society introduced GIR With-Profits Annuities in the late 80's. Although it appears that this was not fully understood, the ABR, which the GIRs thought they were choosing, was in effect their ABR plus 3.5%, in fact the TRL, and that action transferred more of their annuity income into the un-guaranteed FBA. Arguably, an offer of a guaranteed 3.5% rate must have been very attractive to a prospective annuitant but as it happens, it exposed the annuitant to a much greater risk in the event that the Society decided to withdraw the un-guaranteed part of the annuity. The GIR annuity type was phased out in 1996 for what are now, with the benefit of hindsight, obvious reasons since it is clear that the Overall Rate of Return to achieve a stable annuity was no longer realistically achievable. In the case of one annuitant, in order to achieve similar levels of annuity, the ORR would have had to remain at approximately 11% for the last 14 years, a completely un-realistic objective in the financial conditions of the time and today.

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)

3. As the GIRs became increasingly un-marketable, these were replaced with non-GIR annuities of the type illustrated. The DBR for these new policies was much higher than the apparent DBR of the GIR's, which during the parallel period was always set at the rate for the non-GIR annuities less, 3.5%. It is understood that the Financial Ombudsman Service and the Pensions Ombudsman are considering if this differentiation was permissible.
4. These new non-GIR annuities have a lower TRL and thus were able to show initial steady growth of the Total Gross Annuity, as the TRL was less than the ORR, an essential pre-requisite, though by the start of the Millennium even these annuities began to show a slow decline in results.
5. In 2000, just before the time of the Compromise Deal, the Society reduced the DBR to zero where it has remained ever since, further increasing the relative size of the un-guaranteed and un-protected FBA element and which the Society can remove at a stroke.

The actions of the society raise many questions such as, why was it that:

1. At the very time the Society was seeking to reduce its commitments to the WPAs in 2003 when it applied the so called "20% reduction", in the preceding three years it had taken steps to increase the FBA so that it had the maximum amount available for that purpose? You will note that in the table above, the FBA as a percentage of the TGA increased from 15.3% to 26.5% from March 2000 onwards.
2. The DBR has been set to zero well in advance of the announcement of the Compromise Deal? This suggests there was a clear long-term plan to increase the un-guaranteed element of the annuity, the FBA, so that the funds of the WPAs' could be used to meet the financial objectives of the Society.
3. In the same year of the 2.5% uplift, the ORR was significantly reduced from previous years? The effect is to nullify the 2.5% uplift, which added nothing to the income of the WPAs and by implication therefore cost the Society anything.

As for the future, in order to maintain a level annuity the Society has to produce an ORR of at least equal to the ABR (and implicit TRL) chosen by the annuitants. By definition this has to be at least 3.5% but for the majority of annuitants the ORR has to be at least 6.0%. This is quite beyond its current capability as, according to the Society, the funds are now invested in secure but low interest or low dividend investments. It is probable that the income for all WPAs will gradually decline at a rate that reflects the difference between the ABR chosen by the annuitant and the probable ORR that the Society might achieve.