# AN EQUITABLE ASSESSMENT OF RIGHTS AND WRONGS

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# SUMMARY AND OVERVIEW

**Overall objective**
This article attempts to provide a general picture of what the underlying problems were at the Equitable Life Assurance Society, and hence how the different classes of member have been wronged and suffered losses. Without it there is no yardstick by which to judge the relative importance of its many aspects, or balance the conflicting legal opinions that spring from different interests and which are otherwise a premature distraction. With it we can make the necessary assessments, and gauge the appropriateness of other broadly based opinions such as the Penrose Report when they appear. We may also develop it further as other relevant facts emerge, and carry the new understandings forward as circumstances dictate. But for the Internet and the work of many people thereby made available, the task would be impossible. From it the important facts, representativeness of extracts, and the faithfulness of abstracts in the main article can mostly be checked. The result is as much story as picture, and it touches a number of areas: historical, actuarial, insurance, business and marketing, investment and financial, accounting standards, loss adjustment, socio-economic, legal, ethical and regulatory, institutional and corporate governance, and political.

**Sophisticated Plans and Practices**
Of central importance were seminal decisions and actions which took place prior to 1989/90, i.e. around the time that Guaranteed Annuity Rate (GAR) policies were discontinued. They overturned the traditionally successful business and insurance paradigm of the With-Profits Fund, affected all policies sold subsequently, and adversely influenced the manner in which the Fund was administered and represented. Sophistries were the bedrock, and it is also relevant that they are in essence antithetical denials of the major lessons previously learned in the Society's own history. Of special importance was an overarching sophistry to the effect that a With-Profits Fund could be run on what has euphemistically been termed a negative technical solvency gap. This arises when the sum of all total policy values exceeds the assets, whereas absolute insolvency arises when the assets are exceeded by the sum of the guaranteed portions only in all policies. These two criteria can give rise to very different valuations and expectations of the asset shares of individual policyholders.

Though the un-guaranteed portions are unconsolidated, and might do multiple duties to cover other contingencies until required, ultimately they are a "moral charge" on the assets. In times when the unconsolidated terminal bonus element of policies is high this becomes important. The Society maintained that it was in practice unimportant, because its declared practice was to pay out total policy values (including the unconsolidated element) in full, such that this was policyholders' reasonable expectation. Effectively, therefore, the moral charge was thereby made a real one, and the difference was only unimportant so long as the technical solvency gap remained small or intermittent. But since this also implies a reserveless scheme, which could only work given well-nigh perfect forecasting, this was a vain and fallacious hope. Other actuaries were unhappy with all this, essentially because it betokened a fund with scanty reserves, and perhaps insufficient financial strength in the event. Actuaries were also concerned that all policies were indiscriminately placed in the same unitised fund and asset mix, irrespective of their maturities or levels of guarantee, because under conditions of technical or absolute insolvency some policies would acquire inequitable claims on the remnants of the fund. Not surprisingly they wanted policyholders and their advisers to be informed of the potential risks that all this posed in accordance with the Financial Services Act of 1986. To this the Chief Actuary of the Society paid overt lip service, but in practice nothing effective was done in over a decade afterwards. And so all the important omissions, dissembling, concealments and deceits stem from this sophistry, including dual and conflicting presentations of the new paradigm, firstly to a select but sceptical actuarial forum but then not the Society in full, and secondly of the accounts, an optimistic total policy asset share value version for members and a pessimistic discounted policy value asset share version for the regulator, which enabled the Society to survive for so long.

**The Slippery Slope**
The solvency gap arose because the Society's estate had disappeared, or was in process of doing so. How, why and when this occurred is a matter of pivotal forensic importance, because the central sophistry sprang directly from it. In the Equitable's long history members and outsiders have repeatedly been tempted to raid the estate, and the Boards of Directors and the actuaries of the day had resisted this. It is therefore important to ask what other influences affected the Board and management on this final and fatal occasion, and if so why they were allowed. The resulting gap led to the transition from a With-Profits Fund for old and established members to a With-Liabilities Fund for newer and future members, which in turn

could not have happened unless the fund also degenerated into a Ponzi pyramid selling scheme, fuelled by irresponsibly high bonus declarations and total policy values. In this it resembles the Lloyd's debacle, and the ensuing "recruit to dilute" campaign whereby asbestos claims liabilities were transferred from old to new "Names". Hence there is also a need to find out from what level in the Society any "incentivised ignorance" of sales personnel originated. This must be balanced against the more innocent picture of an office which was unduly influenced by commercial and marketing considerations and expanded too rapidly, giving away overmuch as incentives to gain new business and incurring excessive strain on any remaining reserves in the process. The Society may also have ascribed overmuch importance to the profitability of investments in its sole asset mix when investment certainty and insurance should have been its overriding priority. Though there may be elements of truth in this, it does not explain the Society's persistently duplicitous and irresponsible conduct or the origins of the faulted paradigm on which that conduct was based. Nor does it explain why the repeated warnings against injudicious expansion by eminent actuaries in the Society's own past were also neglected.

The coherence, consistency and duration of the ensuing misdemeanours indicate that when traced fully backwards they will have relatively few origins. They are also tantamount to fraud because they satisfy its cardinal elements. These are:

- Knowledge of facts, events or circumstances by one party;
- Misrepresentations (including non-disclosure) of that knowledge in dealings with another;
- Reliance on those misrepresentations by the second party;
- An agreement, contract, or transaction between the parties which a reasonable person would not have entered into if privy to the first party's knowledge, and
- Harm or damage to the second party as a result.

Human nature and corporate life being as they are, there is no point in calling for a witch-hunt until it is clear to what extent the situation was a response to the pressure of evolving circumstances, or was more deliberately contrived. What those circumstances may have been, and the corporate and contemporary culture through which they may have operated is also explored at some length in the main article. And if the Society's descent into fraud was insidiously cumulative, many officers and directors are likely to have been either too closely or loosely engaged to be aware of what the whole amounted to. Even so one cannot escape the conclusion that some did know, or perhaps that others too long suppressed their real doubts. For the sake of the innocent this needs close attention.

**The Fall**

The underlying situation all this created was thus highly fertile ground for future trouble. In the 1970's there had been brisk inflation and high interest rates such that equities also increased in monetary value and many pension funds began to acquire surpluses; at the same time traditional safe investments like fixed interest securities became less attractive. But when more normal conditions eventually returned interest rates fell and there was an eventual secondary reactive dip in the value of equities, which were no longer an indiscriminate hedge against inflation. Under these circumstances growing numbers of earlier policyholders (pre-1988) exercised their rights to guaranteed annuity rates (GAR) when they retired and took their annuities. The Equitable With-Profits Fund became technically insolvent, and to such an extent that the Society reneged on policyholders' reasonable expectations by cutting the terminal bonuses of those exercising the GAR option. As is now common knowledge, the House of Lords deemed this selection against one group of policyholders unlawful, and this decision precipitated the current crisis.

Another expensive crisis waits in the wings, because when the Society stopped policies with the GAR option, from 1988-96 they awarded a guaranteed interest rate of accumulation of 3.5% per annum (GIR) to policies until they matured. In practice this could be arranged to cost it little or nothing, mainly because although the accumulation rate was guaranteed, the proportion allotted as guaranteed and un-guaranteed annual bonus was at the Society's discretion. What the product particulars did not relate is that once an annuity was taken, the minimum total rate of return to ensure it remained level was also raised by 3.5%, such that it suffered an automatic below-the-line compound drain rate 3.5% p.a. on both its guaranteed and un-guaranteed elements. Hence GIR policyholders and annuitants are at a disadvantage compared to earlier GAR and later non-GIR policyholders, because their annuities erode at a greater rate. Ironically, now that the fund is closed to new business the Tontine effect also threatens to disadvantage GIR policyholders selectively versus newer policyholders who do not have them. Increasing life expectancies will exacerbate this problem, and place more strain on the remnants of the fund. Alas this issue was not addressed in the Compromise Scheme, which is why further troubles now threaten.

**Causes and Consequences of Regulatory Failure**

Though individual actuaries had between them spotted the big trees, their vision of the whole wood was less clear. Neither they nor the Government Actuary's Department appear to have articulated it. They had, however, been informed that the paradigm they faulted had been presented to and deemed attractive by an unspecified number of policyholders. This may have allayed their suspicions somewhat, but it begs the question as to why, if the paradigm was so well received, it was not thereafter disseminated to all policyholders and their representatives either as a whole or in any reasonable degree of detail. Beyond this, lack of awareness by the profession of its own history and communication deficiencies in the regulatory network identified in the Baird Report may have contributed to the ensuing regulatory failure. But in practice, no regulatory apparatus can function any better than the milieu in which it operates. Sadly, the informing and guiding influence of Government was also deficient; had this been better exercised the consequences of regulatory failure would not have attained their present dimension. Instead the Government has chosen to be inactive and silent, which gains it three advantages:

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

This is a familiar position, and in that the deficiencies occurred long before, during and after the Compromise Scheme vote, both political parties may have some responsibility for it. Here warily recall that the government of the day indemnified Lloyd's by special Act of Parliament before the Lloyd's Bubble burst. It would be unfortunate for Her Majesty's Opposition if this now inhibits them, because the Equitable Bubble is big enough to involve around 2% of the electorate directly, not to mention their dependants. Moreover this inaction has had three enduring consequences for the Society and its members:

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

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

**Basic Wrongs Suffered by Policyholders**

At last we can glimpse something of how the various categories of member have been wronged, and gain a more accurate impression of their losses. Most if not all have suffered the following:

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

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

**Expectations of the Penrose Report**

This, then, is the kind of structure that we should expect the Penrose Report or any other comprehensive inquiry to probe, illuminate, refine or expand. If it fails to do so in any important respect then the reasons for this will need to be exposed, and further prompt action will become necessary. To help forestall such an unsatisfactory outcome the main article also attempts to anticipate why it might come to pass. In that lamentable event Equitable victims and the electorate must also remind Government of its responsibilities, and lay them plainly at its door.

## 1. Introduction

This article is an attempt to address the various factors that together determine how clients and members of the Equitable Life Assurance Society have been wronged, such that they have suffered or may yet incur loss or damage precipitated by the GAR (Guaranteed Annuity Rate) issue. It is now clear that the GAR crisis was but one symptom of a deeper malaise. Hence a prerequisite for the analytical assessment of wrongs is an effort to establish what that underlying malady was. Though interesting, current analyses are too narrowly legal or financial, and so a wider perspective is now appropriate. Current analyses are also premature, because the Penrose Report should provide a more searching and definitive diagnosis than we have at present. Even so, it may be wise to consider what the terms of reference for that opinion eventually might be. For if the Report fails to establish a consensus, or leaves room for significant residual dissatisfactions, we may need some pre-existing criteria to which we can refer if we are to contend that it has fallen short in any respect. This objective is also important in view of the "unmasterly inactivity" on the part of Government over the ongoing pensions and savings crisis. The recent failure of the Parliamentary Ombudsman to act responsibly is in this respect ominous; for details see the Equitable Members Action Group's sharp response[1]. It may therefore be necessary to maintain the general momentum of inquiry should the findings of the Penrose Report be vetoed by the Treasury, delayed, not released in full, or otherwise watered down. Even so, pre-existing criteria will not be helpful unless they are also realistic, or if there are no practical means of establishing them. We shall return to this subject once the scope of this article has been defined, and the more significant items have been discussed.

## 2. Governments, Regulators and the Society

When the GAR crisis was precipitated by the House of Lords judgement, there was widespread consternation among the many parties with an interested responsibility in the matter. Naturally enough, none of them can have wished to be held any more accountable for the situation than the emergent facts might ultimately dictate. The overall pattern of events strongly suggests that their first instincts were to review and cover their respective positions, such that their obligations to manage the situation positively may have taken second place. In the case of the Government, Treasury and the regulators this was particularly unfortunate, and the defining moment came when Mr Christopher Chope, the Opposition Treasury Spokesman, asked *inter alia* the following question in the House of Commons on October 31st, 2001 (Hansard Column 979)[2]: *"Is it right that the FSA should be giving no guidance to individual policyholders about whether to accept a compromise? Is the FSA certain that, in the event of a compromise being accepted by policyholders, Equitable Life will be able to withstand large class actions alleging general mis-selling of with-profits policies, brought by those who have left the Society? Unless there is some certainty about that, even if the compromise is accepted, Equitable Life might go into insolvency."* Hansard does not indicate that this question was answered, which may in part explain why Mr Chope returned to the matter on November 9th, as follows (Hansard 491)[2]: *"To ask the Chancellor of the Exchequer what assessment he has made of the impact on the future for Equitable Life Assurance of the society compromise due to be voted on; and if he will make a statement."* To this Treasury Spokesman Ruth Kelly replied: *"This is a matter for the board of the Equitable Life and the members of the society."* And since the writer had previously put Mr Chope's first question to the Chairman of the FSA in person[3], and had already received a noncommittal reply from him[4], it was thereupon finally clear that the Society was (and indeed always must have been) entirely on its own, such that its new Board could do no other than paint the rosiest picture it could of a very stormy prospect in order to contain the situation and limit the damage. Here an important proviso is that it was cognisant of its inheritance when it proposed the Compromise Scheme.

Though the new Board deserves everyone's sympathy in this, we should note that this pink picture included a conservative GAR liability estimate at 1.5 billion pounds, and the clear statement that any compensatory litigation would be on a case-by-case basis. This implied that there was no general case for class actions, and that litigation would be piecemeal and comparatively trivial. But as had been urgently pointed out to the Society[5], Government[6], the FSA and its chairman at the time[3,6], this went against the grain of the evidence then available, which indicated that widespread or even universal mis-selling had occurred, essentially because the GAR liability was never addressed by the Society's literature and explained to or by their representatives, and there was a clear need to keep the money flowing in. These observations and deductions have since been corroborated, and officially confirmed in that the Society has accepted responsibility for mis-selling, although as yet only for policies after 1998. And in the process it has more recently emerged that the GAR issue was one of several points of contention which stemmed from seminal decisions or actions which overturned the traditionally successful business and insurance paradigm of the With-Profits Fund, affected all policies sold subsequently, and adversely influenced the manner in which the Fund was administered and represented. Hence any resulting maladministration, misrepresentation and mis-selling has a central and generic character. The crucial date when this process began has yet to be established with certainty, and what brought it about is of central forensic importance. Conversely, in our various considerations of the conduct of government and regulators past and present we should expect any rigorous analysis to cover three distinct periods, namely:

1. The role of the DTI/FSA and governments of the day in the events leading up to the crisis precipitated by the GAR issue.
2. The handling, or lack of it, by the present government, Treasury, FSA and the judiciary in the run up to the Equitable Compromise Scheme arrangement.
3. Ditto in the events since the Compromise.

We should also anticipate that the findings of the Baird report[7] into the conduct of the regulator will be followed up and appropriately addressed. This is because there were regulatory requirements for solvency under the Insurance Companies Act of 1982, and for the conduct of business and the obligation to give “best advice” to clients under the Financial Services Act of 1986. As will become apparent, there were matters wanting in both these areas, and so the failure of the regulatory departments concerned to communicate with one another was an important factor in the FSA’s inaction. The climate of co-operation between regulators and the Society is an additional consideration, because the Chairman of the FSA has complained about it openly. On the one hand it may excuse some regulatory deficiencies, and on the other it could indicate a more general irregularity rather than something occasional or incidental. In due course we shall need to know which, or indeed both, might be the explanation. Finally, we should remember that silence and inaction give the government three traditional and oft-deployed advantages:

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

Having thus outlined our fears and expectations in this arena we may turn to the Society, where the majority of our interest properly lies.

### 3. A New With-Profits Fund Manifesto, or Sophistries of the First Order

This questionable subject was broached by Roy Ranson and Christopher Headdon of the Equitable in their paper entitled: “With Profits without Mystery”[8] presented to the Institute of Actuaries in London on March 20th, 1989; an analysis and commentary on it has appeared previously[9]. Headdon delivered the paper again the following year on the 19th February at the Faculty of Actuaries in Edinburgh[10]. As will become apparent, it cannot have been easy to deliver the paper, let alone act on any comments or advice thereafter received, and so we shall later consider why it might have seemed necessary at the time. As to the origins of the changes described, in paragraph 1.1.3 Ranson acknowledged the help of his colleague D.C. Driscoll and the later help and involvement of C.P. Headdon, and that he formulated the position while working for his predecessor, M.E. (Maurice) Ogborn. Though the wording is sometimes opaque, the more important points in the argument can be summarised as follows:

1. With-Profits Fund Members rather than shareholders are the owners of the Equitable as a mutual insurer (Ranson & Headdon section 2.2.1). It is thus their premiums which finance all classes of the insurers’ business, and hence they who receive the resulting surpluses or meet the liabilities. Members who do not participate in the With-Profits Fund are not owners of the Society, and any profits arising from the administration of their funds would pass to the With-Profits Members.
2. This said, the returns made from other business should be small, because otherwise the principle of mutuality would be denied to non-owning members not in the With-Profits Fund (R. & H. section 3.3.7).
3. The current generations of living With-Profits Members also own the Society’s accumulated asset estate, which includes all unassigned assets not reserved against known liabilities. It can therefore be distributed to them in proportion to their (current) asset shares (R. & H. 3.2.1).
4. Current members also own the liability estate, namely those assets reserved against known liabilities, whether actual or foreseeable. Ordinarily the actuary has then to ensure that this reserve is sufficient in the event, but without being excessive. In effect, therefore, it forms the main smoothing reserve of a With-Profits Fund. However, if the fund is effectively run as a pooled unitised managed fund which is

ultimately (if indirectly) rooted in current market values (R. & H. section 3.2.4), then the smoothing reserve need only be minimal, and the deemed excess can also be distributed to current members as their policies mature.

5. It is thus possible to dispense entirely with the concept of an estate, and the former asset estate not used for the benefit of current With Profits investors can be termed an investment reserve for the financing and development of existing and new business. The unconsolidated surplus (i.e. non guaranteed bonus fraction) of the with-profits policyholders then becomes the main source of the reserve (R & H sections 2.1.2(iii), 4.1.1 & 4.1.2).
6. Should the remnants of the asset (investment reserve) and liability estates become depleted such that they are together less than the potential liabilities, the fund will reach technical insolvency. Under these circumstances, however, existing With Profits members can be regarded as underwriting the technical solvency gap (R. & H sections 2.1.2(iv), 3.2.16) to the total value of their unconsolidated bonuses (and *in extremis* future premiums). Only when the solvency gap exceeds this total value is the fund insolvent. (See R. & H. section 3.1.3).
7. This being the case, the fund can be operated equally well with a negative as a positive technical solvency gap for greater or lesser periods of time (see again R. & H. section 3.1.3), and maturing policies can continue to be paid at the full value of their guaranteed and unconsolidated portions. And over time, therefore, the intention and practice of payment in full will become established as "policyholders' reasonable expectations", and used as a market advantage. In these relaxed circumstances, payment in full is what matters, regardless of the proportion of the guaranteed and unguaranteed elements (R & H section 3.2.6). A further element of flexibility can be gained if the guaranteed portion is made as small as possible.
8. If payment in full is the norm and there is no practical difference between the guaranteed and unguaranteed portions, then it is simpler, and indeed permissible, to pool all the different types of guarantee-containing policy as well as those that do not have them into one fund, irrespective of what those disparate guarantees are, and what the different generations and classes of member have paid, might have paid, are paying or will pay for them (R. & H. sections 3.2.1 & 3.2.2).

This précis of necessity reads more bluntly and less blandly than the Ranson-Headdon paper. Yet whether we react to it with hindsight or attempt to see it in context, the outcome is much the same. Not only is it pragmatic rather than principled, but also it contains several notable sophistries, all of which were represented as refining simplicities at the time. First and foremost, the traditional estate is not a windfall inheritance to be squandered by the current generation(s), but is rather a charitable benefice held in trust, to be deployed for future generations as much as the present. Secondly, moving beyond disinheriting future generations and requiring them also to finance the "profligacy" of the current one only compounds this unfairness. Thirdly, the actual or potential running on a negative technical solvency gap is the very antithesis of prudent axioms of insurance, and flies in the face of experience, which argues for positive financial strength. Worse, it flouts the core concept of policyholders' reasonable expectations, and the consequent appellation of unconsolidated bonuses and benefits as a "moral charge". For this reason alone the House of Lords Decision was essentially correct. Albeit imperceptibly, such a fund sooner or later crosses over from being a "With-Profits" fund for maturing policyholders, to become a "With-Liabilities" fund for current and future premium payers. As this transition takes place, the fund risks becoming crucially dependent upon future premiums unless very definite actions are taken. And fourthly, if guarantees are not meaningless, then they must be properly explained, and charged for openly rather than by stealth. The impropriety of this is compounded by causing those without guarantees unwittingly to underwrite the guarantees of those who have them by placing their asset shares in the same fund, especially when the safety margins of the fund have been eroded deliberately. Subsequent developments require that this be qualified further, as in Section 10.

Not surprisingly, these issues were reflected in the ensuing discussions in London and Edinburgh. To aid continuity extracts and a commentary are given in Appendix I, although they may be read at this point. It will be seen that discussants repeatedly emphasised the following:

- Adequacy and continuity of estate or reserves, to meet the needs of both present and future policies.
- The relative size of terminal and reversionary bonuses in policies, and the need to reserve for them.

- Potentially excessive mutual insurance arising from a pooled unitised fund in which the interests of policies of different lengths and levels of guarantee are indiscriminately placed.
- Given that the investment profile of a pooled unitised fund cannot be ideal for all policy types and durations, an additional mismatching reserve must be held.
- There is a consequent need to explain the potential inequity and risk this poses to policyholders and their advisers.
- Conversely, there is a need to explain the relevance of the guarantees, and how they will be met and charged for.
- Concerns about financial strength under all circumstances, given that the unconsolidated bonus element is used to take up new business strain while continuing to be paid out in full in the absence of an estate.
- The resulting duties of information. For ease of reference the extracts pertaining to this in Appendix I have been italicised.

Mr Roy Ranson closed the Edinburgh discussion for the Equitable. The full flavour of his remarks should be enjoyed entire and *verbatim*, but space must be found here for the following:

"The Paper covers practically the whole range of activities associated with the operation of a predominantly with-profits office. *The kind of points made through the paper are discussed with the Board and senior colleagues very much in the way we put them in the Paper (the wording is a bit different on occasions) and to the extent that we can, with policyholders. That of course is a difficult exercise but we are making efforts."* This now seems an over-liberal, rather than a too economical version, of the emergent truth. It will be interesting to learn in due course how far Board Members past and present (and the non-executives in particular), let alone local office representatives, now agree with him. It seems unlikely only to be humble policyholders who do not. And:

"Regarding the estate, of course we do not have objections to its existence and of course if it exists it is of value to existing policyholders, but I will keep asking the questions: - who created it, which generation, and why was it created? Those points need to be taken up and answered. What contribution is required towards it from the current generation? When are the holders of estates going to tell the public what it is all about? How did they have this flash of inspiration to create it and who paid for it? Who is going to go on paying for it? As a matter of interest I did not inherit one so perhaps that influenced my views." One can admire the sheer effrontery of this, but still must ask- had Ranson also helped spend what he might otherwise have inherited?

Bombast aside, Roy Ranson's remarks now look disingenuous. He above all others present should have known the answers to the rhetorical questions he posed, since they are given in his predecessor Maurice Ogborn's bicentennial history of the Equitable[11], published in 1962. Richard Price, DD, FRS (1723-1791) was a nonconformist minister, a friend of Benjamin Franklin, the Rev. Thomas Bayes and Adam Smith, and a leading radical figure in the English Enlightenment. He was also a not inconsiderable mathematician in his own right, and one of the earliest and most important formative influences on the Society from 1768 onwards. In 1775 he wrote that £4,000 or £5,000 should be "established as a reserved stock…never to be entered upon except in seasons of particular mortality…the interest…to be added to the principal, till it shall rise to such a sum as may be deemed a sufficient surety to the Society in all events (Ogborn p104)."

Price was also instrumental in securing the appointment of his nephew William Morgan, FRS (1750-1833) who rapidly succeeded to the post of Actuary at the Equitable, and by whose probity and prudent industry the Society was raised to unparalleled eminence and prosperity in over fifty years of his service. At his uncle's instigation Morgan conducted the first valuation of 1776, and wrote an early book entitled: "The Doctrine of Annuities and Assurances on Lives and Survivorships" in 1779. Ogborn (p108) described how Price took the opportunity to give the Society some good advice in the introduction to this book. Price had given only qualified approval of the reduction of one-tenth in the premiums which had followed Morgan's valuation, for he disagreed with the return of the "whole overplus":

"Different opinions have been entertained of this measure; but the truth is, that (however safe and just the prosperous state of the Society then rendered it) it is in itself a measure of the most pernicious tendency…A repetition…might hurt the Society essentially, by withdrawing from it that security which it has been providing for many years, and bringing it back to infancy and weakness." True words indeed, but even then there were detractors, *viz* the rejoinder: "Ergo - A Society or company not encumbered by such engagements may safely make that reduction and charge only as much premium as the value of the life requires." This comes from annotations to the preface in a copy of Morgan's book owned by an original director of the Pelican, a rival Society (Ogborn p135-6). Not so safe in the event, because the lean scheme can only work given perfect forecasting; thus it may be considered only to be dismissed. More than two hundred years were to pass before the point was decided at the Equitable itself.

Back now to Roy Ranson, who continued: "There were quite a lot of comments about mix of assets and asset shares. We quite deliberately do not look at individual contracts and I think that when considering that point, we need to bear in mind that for all practical purposes, I repeat *practical* purposes, our business is all effectively short. We have contractual guarantees with a very wide range of pension ages on our business (80% of our business is pensions). There is also a contracted payment basis on prior death. <u>In practice, we also pay full value on withdrawal and surrender at any time. That is not guaranteed and that could be the first thing to go if things got difficult.</u> On the regulatory side, we take account of the earliest possible contractual age for pension purposes in the costs of our guarantees." Here Ranson himself gave the lie to First Order Sophistry Items 7 & 8; *practical* realities later determined that he could not have it both ways.

"On investment mix, we made a point in the paper that we try to keep the balance between declared and final bonus such that it does not influence investment strategy. What I mean by that is that I like to advise the Board, whom I advise each year on investment strategy, that investment managers may form their own views. The mix of assets we have is a direct outcome of what our investment managers choose to do. It is five years or more since I recommended any kind of investment constraint. On the point of asset mix we are always puzzled as to why these offices which promote to (sic) the philosophy that, as you approach maturity, you move into fixed interest, have such high proportions of fund proceeds in terminal bonus?" This pictures the Equitable as an office less concerned with assurance than investment return, and it is consistent with the notion that the management was unduly influenced by commercial and marketing considerations[9]. Here we may note that over-rapid expansion can create a very heavy weight of potential claims (i.e. strain) on a life assurance office. In essence this is because the assurance element dominates in the early phases of a policy before much premium income has been received, and so the ratio of assurance obligation to asset share is high. And if the number of policyholders doubles rapidly because of an indiscriminate influx of new and younger members while the size of the estate or reserves remains constant, the additional demand can erode the reserve safety margin. At the same time the newcomers expect their share in the benefits of the estate in due course, but this expectation must diminish as their numbers increase unless appropriate measures are taken to increase the estate *pro rata*. Longer established members therefore have an interest in keeping the rate of influx down, so that their asset share is maintained. If not, they may demand that a higher proportion of the surplus is given to them. Hence one way a bubble threatens, and on the other stagnation looms- a classical dilemma which dogged the Society into the second half of the 19$^{th}$ century (Ogborn Chapters 11 & 12)[11] and will surface again later.

All this aside, as will later emerge it is also pertinent to ask why, if part of the reason for presenting the paper was, as it should have been, to seek peer review and advice, the various caveats and advice (and particularly the items in italics which relate to the duties of information, to which Roy Ranson himself had paid lip-service) were neither heeded nor acted upon. Suffice it for now to note that as a result it may be concluded that there were germinating seeds of maladministration, misrepresentation and negligence in the ground no later than the end of March 1989.

**4. Illogical Consequences, or Sophistries of the Second Order**

For a mutual office only the first two of the numbered statements in the preceding section have any axiomatic force. The remaining six and their conclusions remain propositions. As the foregoing account has demonstrated, they have not been proven and might even then have been discredited. It is thus doubly inappropriate to enshrine them as premises, and use them to support a second tier of argument. And yet this is in effect what was done. The more notable second order fallacies are:

1. The Society has disbursed, or is in the process of disbursing, the majority of the asset and liability estates to current members whose policies have matured or are about to

do so. This is analogous to a return of capital to shareholders, for which there is ample precedent.

2. Thereafter a smaller *masse de manoeuvre*, or strategic investment reserve that can be used for business development or short term smoothing will be retained, but no other working capital is needed. The With Profits Fund will then move from a predominantly asset-financed to a leaner occasional liability-sharing insurance model.
3. If the unguaranteed portion of members' stated total policy values is being used to cover a (we hope temporary) technical solvency gap while total policy values are being paid out at maturity as they arise, it is permissible to show undiscounted policy values to individual members, but to use discounted values for determining the absolute solvency margin when making operational decisions at Board level and below. Likewise, it is only the absolute solvency margin that is of legitimate regulatory concern. Under these circumstances it would surely be undiplomatic to reveal the size of the discount to individual policyholders, since this represents a liability and they are trustfully expecting continued profit. It would be similarly inconvenient to draw the regulator's attention to the size of the technical solvency gap by calculating the total current liability as measured by the aggregate of undiscounted total policy values.
4. When the technical solvency gap has taken up most of the unconsolidated and unguaranteed portion of the fund, it will become necessary to deduct the value of any optional guarantee (if exercised) from total policy values at maturity in order to maintain absolute solvency (rationale underlying the Dec 22nd 1993 GAR Differential Terminal Bonus Policy Board Resolution).
5. In more extreme circumstances the value of the optional guarantee (if exercised) could come to exceed the total discounted policy value at maturity. If this difference were to be deducted from the guaranteed portion itself, then a) the guarantee would be breached and b) the fund would be *de facto* officially insolvent. Hence when this point is reached it should not be indicated, and a sum in excess of the policyholder's discounted asset share must be paid out, which can only come from the Fund's other pooled assets (rationale behind the 1993 GAR Board Resolution amendment).
6. Regardless of whether later economic circumstances will make them worthwhile, at least the full value of non-optional guarantees will be clawed back. In the case of guaranteed interest rate annuities, the annual rate of return that ensures a level annuity is guaranteed by 3.5% p.a. This safety feature is a selling point, and will become part of the policyholders' reasonable expectation. On the other hand, policyholders might be displeased to find out that the necessary rate of return to keep the annuity level will be increased annually by the same amount as the interest rate level portion that is guaranteed, i.e. 3.5%. As a result both the guaranteed and un-guaranteed portion of the annuity will progressively diminish by 3.5% p.a. regardless of whether the fund earns less than that amount per year for any length of time[12]. This will help the Society by extending the technical solvency margin of the With Profits Fund. Hence this aspect of the guarantee should not have any prominence in sales details or product particulars. (Cf. Section 10 below; R & H sections 3.1.4-6, 3.2 & 3.3.2).

Any forensic terrier worth its keep might now dispatch these six rats in short order: viz- assuming this is what happened, (1) is inconsistent with the concept of ongoing mutuality, and hence fundamentally improper. (2) undermines the fundamental concept of a "with profits" fund, and so over and above requirements for regulatory financial strength it must be fully disclosed and not covered up as in 3). (4) makes the optional guarantee worthless, and (5) makes others underwrite that guarantee if exercised. Non-optional guarantees that are eroded at full value regardless of whether they are needed as in (6) are no guarantees at all at best, and automatic penalties at worst; they are also a two edged sword because of the established custom of paying policy values in full. Hence they merely transfer the Society's obligations from the guaranteed portion to the "moral charge", of which more anon.

It is therefore hardly surprising that these points remain matters for the courts, the Financial Services Ombudsman and the regulators. The details are, however, beyond the remit of this article, the main purpose of which has been to reveal the coherence, consistency and duration of the structure of which they as wrongs form a part, and to demonstrate their individual places in it. Nevertheless this objective is an essential prerequisite for the assessment of any underlying element of fraud, and there is otherwise the danger of its being overlooked in piecemeal wrangles over the separate issues.

**5. Awarenesses, Apprehensions and Inhibitions**

Paragraph 3.2.10 of the Ranson-Headdon paper implies that the various changes summarised above were being implemented at the end of 1982 (i.e. the year of the Insurance Companies Act, to which there may be a connection), and so they may have been well established before 1988 when the decision was taken to stop offering GAR policies. If so, they may have been accompanied by a growing awareness which culminated in the conscious realisation that a crisis point was approaching, or was indeed already inevitable. We should thus also consider the extent to which the Ranson-Headdon paper was an attempt to stem potential rumours to this effect. However, the contemporary "climate of disclosure" alluded to by H.W. Froggatt (Appendix I Section I) may also have been influential. In 1986 Marshall Field delivered a philosophical Presidential Address to the Faculty and Institute of Actuaries, which was entitled " Risk and Expectation"[13]. He sought to open up debate on the shift from basic insurance towards investment and the difficulties that this posed, particularly during periods of inflation, and indeed the reverse when interest rates were low and taxation high. He discussed the emergence of the concept of policyholders' reasonable expectations, attitudes to risk and strength, more stringent requirements for disclosure of material information and regulation, and fairness in distributing surpluses with particular reference to the early experiences of the Equitable Life Assurance Society. C.S.S. Lyon followed this up more practically in 1997 and 1998 in a paper entitled " The Financial Management of a With-Profit Long Term Fund- Some questions of disclosure."[14] Lyon was also motivated by the impending requirement, stemming from the Financial Services Act 1986, to give an investment client, including the holder or prospective holder of an insurance savings contract, what is described as "best advice". Both Lyon and Field were interested in the fact that, because of the investment aspect, terminal and reversionary bonuses were becoming an increasing proportion of with-profits policy values. In section 1.2.3 of his paper Lyon wrote: *"Future terminal bonus on existing policies can represent a major moral charge on the excess of assets over published liabilities, but the extent of this charge is not quantified in the returns."* Now in that the Equitable's declared position was to pay full policy value at maturity or surrender such that there was effectively no difference between the guaranteed and unconsolidated portions (i.e. First Order Sophistry Item 7), this moral charge was made a real one. And in the discussion none other than Roy Ranson said (p403): *"I support the author's suggestion that the, to use his words, "moral charge" which existing terminal bonus has on the free assets might be reported. If the free assets remaining after such an exercise were used as a sign of so-called "strength", such a disclosure would need to be supported by a note about the office's approach to with-profits business."* Lyon's assertion and Ranson's reply reach the very heart of the tragedy that was to follow.

Mr. R.C. Wilkinson was the last discussant of Lyon's paper, and so it is curious that his short statement may now be viewed as its epitaph. It reads: "There has been much discussion about the solvency margin shown in Form 9 of the DTI Returns and the lack of any specific comment about a reserve for accumulated terminal bonus. A more fundamental point has to be addressed which relates to the proportion of reversionary bonus which is actually allowed for in the published valuation basis.

The size of the free reserve demonstrated in Form 9 for larger companies runs not into hundreds of millions, but billions, and in some cases represents a figure well over 25% of total assets. If a comparison is made of the with-profit valuation basis between these offices there is a significant difference and I would contend that in some cases only a partial allowance is being made implicitly for future reversionary bonuses. This is despite Guidance note 8, §2.1.3 which states: "<u>Actuarial principles require the actuary to pay due regard in his valuation to the future interests of with-profit policyholders notwithstanding the fact that Regulations 55-64 do not specify the point.</u>

*A comment needs to be made when reporting to the GAD and the DTI on what proportion of reversionary bonus has been allowed for in the statutory valuation basis. This figure would be very significant and should be published to give some guidance to intermediaries when they are looking at assessing the problem of best advice. This situation also impinges on policyholders' expectations and if the appointed actuary is only loading for a proportion of the current reversionary bonus rate he is not having total regard to this point."* Again the underscoring and italicising in this statement are the present writer's; readers are invited to reconsider the import of Roy Ranson's own words and Second Order Sophistry Item 3 in relation to any loopholes afforded by the contemporary regulations.

Meanwhile, in that the Equitable's position and practice were to say the least out of line with the tenor of these opinions, some justification of its stance must have seemed sensible. From the previous section it is clear that the central ground to be defended was the absence of an inherited estate. So, was the Society compelled to make a virtue out of necessity, because the estate had already disappeared? How large had it been? Where and when did it go? The implication is that it had been or was in the process of being distributed to former and matured policyholders, but if that is not entirely correct it is under these circumstances important to establish what else happened. Here note that Marshall Field had also alluded to the Society's further difficulties over the equitable distribution of surpluses in the early 19$^{th}$ century and, as we shall see, this holds further pertinent ironies for us in our effort to understand how surpluses may transform into liabilities.

What aggregate awareness of the overall situation was there in the Society itself? It is almost a commonplace that a state of affairs will become obvious to one or several people almost simultaneously, such that it becomes an informal if as yet unvoiced collective preoccupation, which nevertheless influences the stance of the group. Not to raise it may appear tactful or sensible, but sooner or later a conflict with personal integrity becomes inevitable in most cases. Beyond that point continued silence is dishonest, and this is compounded if the situation becomes more actively concealed. By definition there will be no written record of this state of mind, and often for some time after it has arisen, but it can reasonably be inferred from the record of presences and actions under the prevailing circumstances. Yet once this Rubicon had been crossed, one or more of the officers and Board of Directors had clear duties of information and care (some of which are statutory) to established and prospective members of their Society and to the regulators, however embarrassing and uncomfortable those might have been. It may also reasonably be inferred that, had the duties of information earlier and publicly identified by the discussants in Appendix 1 and even Roy Ranson himself been complied with, there would have been much less initial inhibition to break through, and that this might have saved or ameliorated the situation. But given that the Society's motivation was as earlier conjectured, there was never much likelihood of this happening, and in any case it may already have been too late.

Initial inhibitions of this kind are often greatly reinforced by the fact that the sub-units of society, such as the family and many hierarchies, are essentially feudal rather than democratic. The latter notably include management structures in the many public companies, organisations and institutions. If so, it can be allegiance and subservience to the hierarchy rather than ethically inspired competence that determine preferment and reward, and this risks going too far when those at the top see themselves more as masters rather than dutifully faithful stewards. In times when head stewards are deemed weak if they do not look for more than their due, they had better seek the assistance of like-minded lieutenants and courtiers. These worldly recruits know they will profit by openly endorsing and praising the hierarchy, obeying almost any order or supporting and implementing any received policy, even when they see that these will fail, or that a succession of them will ultimately wither and kill the organisation itself. Conversely, others realise that under these circumstances it is unwise to argue the case, since this is doomed to failure and they risk ostracism or punishment. At this point a material element of fear and repression has entered the equation that few are prepared to resist, such that the organisation has become compromised. This situation has recurred many times in history, and been distilled into biblical parables and children's tales. It is moreover a highly topical issue in the governance and regulation of large businesses throughout the world. Conversely but unsurprisingly this is also a taboo subject in the many managerial textbooks which exude an aura of enlightened management superiority, to which their ambitious readers aspire. All the more reason, then, to ask whether elements of it apply here.

The tips of these feudal pyramids are in theory answerable to surrounding clouds of owners or shareholders through elected representatives on the Board. Much therefore depends upon how the Board views its duties and functions. Though the executive members of the Board are part of the pyramid and must tend their feudal allegiances, they as well as non-executive chairs and directors can have wider and more Olympian affiliations that notably include the larger owners, members of what Anthony Sampson termed The Establishment, and the administrators of group participatory schemes. Some big clouds may thus cling more closely to the top of the pyramid than later and lesser wisps. Almost imperceptibly, therefore, such institutional edifices may come to resemble private clubs, the privileges of which are annexed by an entrenched minority. Best then that any surplus charge accumulating at the tip be leaked into the immediate clouds with unobtrusive efficiency, lest the furies of the previous 1816 lightning storm be repeated. So, could the Equitable have been run to some extent as Lloyd's was for the benefit of older "names", and the burden increasingly laid upon newer members when things began to go wrong?

**6. From Pyramids to Ponzi via Lloyd's, or A Bubble is born**

Maurice Ogborn[11] and Marshall Field[13] relate that the disputed surpluses of 1816 had accumulated mainly because stiffer premiums for a higher mortality (conservatively based on mortality tables from Northampton) had been charged than were applicable to the better social conditions of the Society's members. The origin of surpluses in the 1970's and 80's was more general, and different. Those with a prior interest in the modern primacy of energy in the creation of goods and the implementation of aims foresaw that, when the price of oil rose abruptly by threefold in 1973, a wave of inflation and monetary devaluation would begin, and not work its way out of the system until wages and prices had risen by at least the same proportion. This duly happened, and in the ensuing inflationary period there was a scramble out of money and fixed interest securities and into possessions and assets with intrinsic and durable value. This included equities once the immediate crisis of confidence had subsided, and it led into the longest bull market in history. The market was also drip-fed by underlying real economic progress over the next two decades, of which the digital electronic revolution is the outstanding example. It was also helped by the easing of political tensions as the Cold War came to an end.

Institutions with large equity holdings experienced gratifying increases in their monetary value, and this was further sustained when, once the inflationary wave had been absorbed and dissipated, the unprecedented compensatory rise in interest rates also began to subside. These were heady days for pension funds, and many showed surpluses. Unless a Maxwell asked it their distribution became a legitimate question, and many firms and schemes enjoyed breaks from making contributions in order to take up the slack, or took the opportunity to let older and more expensive staff go on preferential terms. The shareholders of publicly owned life offices must have benefited, but mutuals like the Equitable may have had a more subtle quandary over their burgeoning asset estates. In such cases, growing the business and declaring big bonuses for the existing members would help take care of it, but so too alas would diversions into unwise or inappropriate investments. Meanwhile, the investment aspects of modern life assurance would have made it seem uncompetitive and unprofitable to hold much in the form of what C.S.S. Lyon[14] had called a mismatching reserve, let alone more conventional fixed interest securities in the liability estate, even if this denoted a reduction in safety margin.

Though it took a long time, there should have been no surprise that more normal conditions would eventually return. The rise in stock values abated and then fell as their earnings capability once again assumed its longer-term importance, both in its own right and for valuing stocks themselves. At the same time interest rates fell to historically low levels and the price of fixed interest securities hardened. There was now a squeeze on income, during which premium flows from new business became increasingly desirable. And by the same token the GAR annuity option became of real value to Equitable's maturing policyholders, who took it up in growing numbers. At the same time the cost of providing those annuities was escalating. This was about the worst time in history for the Chancellor of the Exchequer to have abruptly withdrawn tax relief from pension fund earnings, but that is what happened next, and in the ensuing crisis he has been obliviously unrelenting.

The combination of successive guarantees on annuity and interest accumulation rates, a paradoxical but deliberate paring down of smoothing surpluses, and the erosion of the Society's estate were now to prove fatal. The situation had been compounded by tacit pressure to keep paying out inappropriately highly rated surrender values and bonuses in full[15], such that the Fund's reputation for superior performance was sustained and an increasing tide of new premiums flowed in. At the same time new business strain was further eroding safety margins. Sooner or later the resulting bubble threatened to collapse or burst. Although the Guaranteed Annuity Rate issue and House of Lords decision pricked it first, an estimate of the overall cumulative deficit has subsequently indicated that the Society was already greatly endangered[15]. The wonder is that a succession of qualified actuaries devised and implemented this process when they of all people should have known better. What asbestos had earlier and slowly done for Lloyds, the 1973 oil crisis and the loss of its estate may finally have accomplished for the Equitable. Contrast this now with Appendix II, which is a further extract from Maurice Ogborn[11] (p206-7), and ask whether most of the elements in this situation were not already well known lessons from the Equitable's own history. The extract also shows that Ogborn was an advocate of the estate concept in 1962, and it follows that a critical change must have occurred during the transition from his stewardship to that of Roy Ranson. Ogborn chapters 11 and 12 give much more of the Society's history in the same vein. How all this could have been neglected is indeed bewildering.

At its height the size of the With Profits Fund bubble was truly impressive. Between 1957 and 1988 the Equitable had acquired 170,000 members who held GAR rights. By contrast a further 930,000 members without GAR rights were recruited in the succeeding 12 years, which is more like exponential than linear growth[16]. Given that the United Kingdom has some 60 million citizens who may not vote until attaining 18 years of age, this represents a good 2% of the electorate. Put this way, the government's silence on the matter is strangely inappropriate, because it could tip the balance at the next election.

The Lloyds bubble was in numerical terms much more modest. Lloyd's inner circle had continued to conceal their knowledge of massive impending losses while intensifying the aggressive recruitment of more and more external "Names" through members' and managing agents in what became known as the "recruit to dilute" campaign. There were about 6,000 Names in 1970, whereas by 1990 nearly 31,000 new Names had been added. During this process two thirds of the old Names withdrew from the risk, such that the total involved reached 33,000. Meanwhile, in their own version of dual accounting, the syndicates continued to under-reserve and/or inadequately insure for incurred but not reported losses, thus hiding the coming losses and maintaining an illusion of prosperity[17].

Prior to the Lloyd's and Equitable fiascos the most infamous (and hence eponymous) pyramid selling scheme was that hit upon by a nefarious US immigrant named Carlo "Charles" Ponzi, a native of Parma, Italy. In 1920 he sought to capitalise on the fact that he could purchase postal credits abroad for considerably less than their encashment value in the US. Even though the larger scale exploitation of this was impossible, his friends and acquaintances thought it such a good idea that they advanced him money. On this he paid them advantageous rates of interest, which elicited an increasing influx of subscriptions. When it finally emerged that the original idea was unworkable, people demanded their money back and the edifice collapsed, but not before 40,000 people had lost much of their investment.

Not surprisingly, disaffected Lloyd's Names have highlighted the parallels between their situation and Ponzi's victims[18]. Professor David Blake of the Pensions Institute[19] came to a similar conclusion when investigating the Equitable's predicament prior to the Compromise in 2001. He made the point that, because the Equitable had to attract sufficient non-GAR policyholders to help it bail out the GAR policyholders if equity performance was inadequate, the With Profits Fund began to take on the characteristics of a Ponzi scheme when GAR policies ceased to be offered after 1988. He listed the characteristics of Ponzi schemes as follows:

- The high returns achieved by the initial members of such a scheme are paid in part out of the contributions of later joiners.
- They require an increasingly rapid inflow of new members to sustain themselves.
- They end abruptly when the inflow of new members ceases.
- Those who join very late in the scheme's life lose a lot of money.

Professor Blake had no reason to divine that the situation was already both more serious and advanced than this by 1988, and Mr Ponzi's ghost must now surrender his crown to the Equitable as the new champion in his field. Mr Ponzi, though, has a cult following on the Internet for his *chutzpah*. In this the Equitable is unlikely to be as successful.

**7. Probity and honesty, awareness, aversion, passive dishonesty, professed ignorance, denial, active dishonesty, concealment, diversion, deception, fraudulence and criminality**

When it comes to the assessment of culpability and damage, much depends upon whether the above sequence is read in ascending or descending order. Few would disagree that fraudulent intent from the outset is criminal, and hence reprehensible- even a police matter. We may call this first-degree fraud, and must address its possibility in the context of wrongs and damages. But when ordinary honesty yields progressively to the pressure of circumstance, does it ever amount to criminality? Again the stark answer from history is yes, if relatively infrequently. And if the dictionary criterion for fraud is deceit, and fraud is recognised as a crime, there is an inevitable conclusion once the rising scale has attained deceit. This we may term second-degree fraud. As an example, the writer maintains that allowing or causing it to be put about that losing the House of Lords case would be inconsequential was a significant deceit.

The five legal elements of fraud are:

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

With this in mind, it is now evident that the overall coherence, consistency and duration of the Society's stance and conduct have been tantamount to fraud, whether of the first or second degree. Onto this pattern we have been able also to cast the light of the Chief Actuary's own words, and see more clearly the extent to which the expectations of policyholders and fellow actuaries have been betrayed. As a result it is not merely the so-called Late Joiners who have legitimate grounds for complaint because the problems track back to March 1989 at the very latest. Moreover current legal niceties over the conditions under which compensation "as if" for fraud may be appropriate are thus irrelevant, and may now be set aside. In compassionate mitigation one should add that there are also distinct generations of officers and directors, such that the younger inherit the positions vacated by their elders, and not always in full knowledge. The next generation is thus under pressure to justify and defend its inheritance, and so what may have begun nearer the first degree can end in the second. When the stable is empty, it can be rough justice to dismiss the groom if a coachman has made off with the horse. Even so, persistent pretence that the stable remains full is a serious matter, and delays pursuit of the coachman. Once again there is need to recall and examine Roy Ranson's assertion that Board members were kept informed. Clearly this is of greatest relevance to the situation in which erstwhile non-executive directors of the Society now find themselves. A useful insight into this, and to some of the issues opened up in section 5, may be had from Mr. Justice Langley's decision on Oct 17th 2003 to deny the request of ex-directors that the Equitable's case against them be struck out[20].

**8. Mis-selling, misrepresentation, misdirection, and inducement**

The writer maintains that mis-selling embraces all the subsequent categories given in the above heading, and hence that they are subordinate to it. Misrepresentation is holding the facts to be other than they are, and may be unconscious and honest, if then sometimes also negligent or incompetent, or it may be intended and thus deceitful *ab initio*. Misdirection is the recommendation to purchase something specific when the seller knows that more suitable options exist. Inducements include, but are not limited to, an enumeration of the benefits, real or illusory, that may reasonably be expected to attend the purchase. If the seller knows or suspects that there is no real likelihood of these materialising, then they too are falsely based.

In the present circumstances misrepresentation, misdirection and inducement all apply to the various categories of Equitable policyholders. Examples of misrepresentation include inappropriate claims of financial strength and prospects of the With Profits Fund, that the effects of the House of Lords Appeal would be inconsequential, or that the cost to the fund would not amount to more than £50 million pounds. Misdirection in this instance includes the steering of clients towards the inherently unsound Equitable With Profits Fund when other sound funds were on offer by the Equitable, or sound with With Profits funds which were known to exist and to be offered by other insurers.

The writer also holds that, in the case of the Equitable, inducement has been a significant factor. All or nearly all Equitable clients were told that they would do better if they used a mutual office which did not have to pay dividends to external shareholders, and better still if they used one that did not pay commissions to outside salesmen and advisers. They were also told that, in no small part as a result of this, the Society had a high overall administrative efficiency and a much lower expense ratio than its competitors. They were further told, or allowed to believe, that these continued advantages had over many years led to the strength and enviably good bonus record of the With Profits Fund. We now know that the last of these inducements was also a misrepresentation. However, the first two were not. They may properly be regarded as intrinsic benefits stemming from direct collective ownership and expense-free sales. If so, they are rightful and reasonable expectations upon which a defined value can and should be placed. And as such, had the Society been correctly administered, they would have accrued to the lasting benefit of members. If one looks at the dividend paid by other U.K. insurers, we may rate this benefit conservatively as 3% per annum, plus, say,

another 0.5% per annum for the low cost of sales. This must be borne in mind when members' losses are estimated.
Furthermore this combination of benefits appeared unique at the time. This highlights the difficulty (for those such as B. & W. Deloitte at the behest of the Society[21]) who wish to factor in fluctuations in market value by cross-reference to the fate of comparable products offered by other providers when estimating loss and making offers of compensation. But in any case, we shall later see that market fluctuations are by no means the only factor to take into account.

The mis-selling approach has had its value when considering what should have taken place during the exchanges between individual representatives and their clients. It has also been useful in establishing what information should have been presented in the Society's literature, and to its representatives. Even so, it is very much a "bottom upwards" approach. It must therefore be complemented by a "top down" assessment, which conveniently happens to be essentially the same one as for fraud. Here the crucial fact remains that the representatives were kept in material and continuing ignorance of the risks and weaknesses at the heart of the product they were selling. Moreover, they may at the same time have been encouraged to direct clients towards the With Profits Fund rather than to safer investments- key features of a Ponzi operation. The level within the Society at which incentivised ignorance of sales personnel began therefore remains a highly pertinent item, and we should look to the Penrose Report for an authoritative lead into it. Fraud thus again emerges as the dominant and central issue, of which mis-selling was merely a contributory part.

Elements of this section are also relevant to the substantial number of members who were persuaded by Society representatives to adopt the income drawdown option, and so unwittingly forfeited their valuable GAR rights.

**9. The Society versus the Individual**

The Society is not one person, but has many members and advisers, all of whose comprehension and influence are limited. It also comprises a legacy from the dead and departed. How, then, can any one be fully aware of what another intends or intended, did, is doing or not doing? Can that one be always accountable for the other? And if so, what can he or she in turn do? And yet some members must be more capable than others; thus senior officers and Directors are very influential, of necessity very knowledgeable, and beyond that responsible. If a senior officer dissembles or conceals, more peripheral and junior employees cannot always know, let alone suspect, that the basis for their actions has been falsified. Hence in the same organisation negligence and ignorance can compound and exacerbate a deception, but not everyone is equally to blame. Yet because the bad link faults the chain, the Society comes to bear the collective responsibility. Hence the Society may have to assume the whole burden, if not always the stigma, of the most culpable individuals employed in its name, or even sometimes on its behalf.

**10. Critique of the Society's own assessment of its damage**

The Society has concluded that there is a deficit of £ 3.2 billion pounds in the With Profits Fund, which estimate is very close to that of independent outside accountants, such as Burgess Hodgson[22,23]. It is now seeking to recover the whole of this sum from former officers, directors and its erstwhile auditor. The sums sought from the individuals are punitive, and some face ruin from the legal costs alone. Having proclaimed the worst links in its chain, the Society is making them solely and wholly accountable, which is not inconsistent with the conclusions of the previous section. Because of its import we are all obliged to take this exercise at face value, and disregard any public relations, political or diversionary aspects.

We may therefore also take the view that the Society should not seek to be judged by others any less fully than it judges its former self. On this basis former as well as present members of the Society are entitled to their share of full compensation *pro rata*. It must therefore be a matter of astonishment and regret that the Society proposes to offer former members less in compensation than it seeks on behalf of its present ones.

The matter does not end here. The deficit which Burgess Hodgson has identified, and which the Society alleges that auditors Ernst and Young overlooked, is the cumulative disparity arising from a dual standard of reporting non-discounted policy values for members, but discounted values for its own management and the regulator. A memorandum from Equitable actuary Catherine Payne addressed to Christopher Headdon came out in the Ernst & Young case, and it showed that total with-profits policy values exceeded assets in the years 1995-99 inclusive. This enabled Burgess Hodgson to firm up previous estimates[19], and to surmise that a similar situation had obtained in the years 1990, 1991, 1992 and 1994. (It is also of interest that footnotes to the Payne memorandum reveal that the GAR reserve had been kept at £50 million from 1998 into 1999. This may explain the origins of the misleading estimate of the GAR liability referred to earlier, which was apparently held constant despite legal advice by then received. It is also likely to reflect the approximate size of the absolute solvency gap within the GAR segment of the fund as computed under Second Order Sophistry Item 5, which further emphasises the impropriety of maintaining that this was the maximum liability that the Society would incur if it lost the House of Lords Appeal.)

Though the Ernst and Young case is centred upon the reverses of more recent years, it is unlikely to allow even partly for an earlier loss of the Society's estate. This we have previously identified as a crucial question. Until there is definite knowledge of its fate no attempt can be made to recover it, but the likelihood is that this will largely be impossible. Reason enough, perhaps, for the Society not to advertise the matter. Yet as has been seen previously in comparison with other offices, a preserved estate or its equivalent provides a valuable smoothing and strengthening buffer, and is part of the inherent characteristics of a healthy With-Profits Fund. If at the height of the bubble the total valuation of the With Profits fund was £30 billion, and it had been backed by a relatively spare estate comprising only 10% of this (15% is more usual), then we can see that the true loss to the fund is at least 3 billion pounds more than has previously been stated[11]. And if the Equitable With Profits Fund is ever again to function as such, this estate must first be restored. Meanwhile whatever allowance or recompense for its loss later policyholders should be made requires formal debate.

As yet the Society has ignored the effects of a growing tide of complaints about the GIR issue, which though analogous to the GAR one in many ways, could not by its nature have been laid off fully in dual accounting standards. This issue has previously been summarised as Second Order Sophistry item 6. The background to this has been explained in detail by Peter Scawen[12] as part of a more general exposition of how Equitable With-Profits annuities are calculated. When the Society stopped policies with the GAR option, from 1988-96 they awarded a guaranteed interest rate of accumulation of 3.5% per annum (GIR) to policies until they matured. This was mentioned in the product particulars, but in practice it could be arranged to cost the Society little or nothing. In the first place, an initial deduction of 4.5% was taken from each premium, and there was an annual management charge of 0.5%. In the second, although the accumulation rate was guaranteed, the proportion of this allotted as guaranteed and un-guaranteed annual bonus was at the Society's discretion. In retrospect, the first indication that this might be important came from the bonus statements for 1997, when both GIR and post July 1st 1996 non-GIR bonus rates had to be declared, and the guaranteed portion of GIR bonus was 3.5% lower than for non-GIRs. And what the GIR product particulars did not state was that, that once a GIR annuity was taken, the hurdle rate of overall return to ensure it remained level was also raised by 3.5%, such it suffered an automatic below-the-line compound drain rate 3.5% to 4% p.a. on both its guaranteed and un-guaranteed elements[12]. As a result, most GIR annuitants had overall rates of return to keep their annuities level 3.5% higher than they understood them to be.

The situation is further worsened because, during the successive years of the annuity the proportion of annual bonus added in guaranteed or un-guaranteed form to the remaining asset share is also at the Society's discretion. As a result, the proportion of a GIR annuity that is in basic guaranteed form can erode rapidly, as is now the case. All this amounts to a guarantee that functions more like a penalty, and one that can be charged for in full twice over; i.e. both before and after the annuity is taken. Retrospective perusal of R & H[8] sections 3.1.4 –6, which describes the overall GIR charging structure, and section 3.2, which outlines the discretion involved in allotting the guaranteed and un-guaranteed bonus elements, is also useful in understanding the degrees of freedom which allowed this situation to develop. Even so, the R & H paper was written before non-GIR policies were introduced, and so does not deal with the further inequities that resulted from their admixture. As a result the GIR policyholders (i.e. the rump of the With-Profits Fund) are selectively disadvantaged in comparison with the both the older GAR policyholders and the newer non-GIR policyholders, because the GIR annuities erode 3.5% p.a. faster overall. We may also anticipate that now the fund is closed to new business the Tontine effect will also disadvantage GIR policyholders selectively versus newer policyholders. This will be further accentuated if the life expectancy of the newer members is greater than older ones, a factor that might place additional demands on the remnants of the With-Profits Fund in any event. Unfortunately, despite the wishes of some, this issue was not addressed in the Compromise Scheme, which is why further troubles now threaten. In view of the outcome of the GAR issue, the Society may additionally be liable for the GIR one in future, perhaps to the tune of several billion pounds.

On this basis the Society could be as much as £10 billion short, of which it is actively seeking to recover 3.2 billion. The amount recoverable from former directors is likely to be very much smaller.

**11. Loss and Damage suffered by Individual Clients and Members**

Having set out the evidence, we may now addresses the losses and damage that members will have sustained if they left before the Compromise proposals, or declined the Compromise proposals and resigned from the Society. Those who left earlier on may have suffered less, depending upon when and how they quit. The various categories that may be applicable may also vary according to individual circumstances, but comprise:

1. An immediate loss of 16% of their principal, ostensibly to cover the aforementioned deficit, as exemplified by the Compromise offer.
2. A further Market Value Adjuster, which varied between 10 & 20% at different times.
3. An additional but nebulous penalty for unscheduled withdrawal if return of principal had to be requested other than on a policy anniversary (if withdrawal was made before the 5th anniversary of the policy).
4. Loss of mutuality and low expense ratio benefit, which combination was not available elsewhere (i.e. equivalent to approximately 3.5% of the principal in most instances)
5. Loss of benefits due to, and the ultimately fatal risk incurred by, earlier disappearance of the Society's estate.
6. Re-investment expenses (typically 5% for a managed product, plus intermediary commission if not waived).
7. Unnecessary worry, time, effort and incidental expenditure.
8. Legal costs (minimum typically taken to be Solicitors or Counsels advice, Small Claims or County Court Judgement application).
9. Loss of interest from vanished principal and benefits, plus that from monies spent on re-investment and legal expenses.
10. Damages whether civil or criminal, aggravated or not.
11. Harm resulting from the failure of the Treasury and regulator to monitor, advise, protect or otherwise act before, on the eve of, and after the Compromise.

It may sometimes be necessary for policyholders to lump items 1-4 together in order to see what their order of magnitude is, because it is impossible to estimate 3 directly. Consensus on item 10 is still awaited, but the Society is seeking full reparation and legal costs on its own behalf, even before the issue of damage has been considered. How much beyond this should ex-members claim? We have previously seen that, although the Society is accountable for what has been done in its name, it does not necessarily also acquire the stigma of guilt. If so, ex-members should hesitate before claiming exemplary, retributive or punitive damages because it would be unhelpful, and inappropriately hurtful to continuing and innocent members. On the other hand the ex-members are much in the minority, and in many cases they have valued the wish for justice above hopes of personal certainty, whereas the converse may apply to those who voted for the Compromise. In weighing all this we have also to reconsider that since the misdemeanours go back to 1989 at the latest, many more people may have legitimate grievances than previously thought.

Those who accepted the Compromise or were forced into it by disenfranchisement have different categories of loss, namely:

1. Forfeiture of legal rights against the Society and its old and new Boards.
2. Loss of With Profits status of their fund, as a result of:
3. Loss of the Society's estate.
4. Excessive and inequitable mutual insurance, partly caused by unequal guarantees or the hidden penalties thereof; not yet fully resolved.
5. Potential liability for litigation from ex-members (the likely extent of which may have been underplayed).
6. Harm arising from governmental and regulatory deficiencies as in point 11 above.

In essence, therefore, the same duties of information apply to the Compromise as to any other financial product. Accepters may therefore have a case for avoidable losses and damages should it emerge that they were in effect duped into the Compromise. Hence any conditional amnesty may not apply to the new management of the Society, and most particularly should it have promoted the Compromise by using reason or premise that it knew or suspected might be untrue. In this regard four factors are of additional concern, namely:

1) An optimistically low Compromise estimate of the size of the deficit.
2) Holding that mis-selling was not of a generic character, such that future litigation would be piecemeal and trivial.
3) Using and upholding the previous Board's discredited business and insurance paradigm, conventions and practices without substantial modification, to the actual or potential detriment of members past and present.

Item 3 is of particular relevance because of the continuing usefulness of First Order Sophistry Item 7, which now allows With-Profits Policies to be cut to the bone because the guaranteed element is so small. The guaranteed element will reduce yet further under Second Order Sophistry Item 6, which has given rise to the related GIR issue. There is also the question of disenfranchisement of With-Profits annuitants and the consequent burdens laid upon their Trustees, who are now answerable for them. In the case of FSAVC annuitants the Society is both fund executor and Trustee, but Law Debenture Pension Trust Corporation was deputised to vote on the Compromise Scheme arrangement on their behalf to avoid a conflict of interests. The Legal Services Department of the Equitable has confirmed to the writer that Law Debenture received the same data, i.e. the Scheme Circular, as individual members, and returned its ballot form in the assent without reasoned response or comment. If this does not inspire other classes of annuitants with confidence, they may wish to contact the Legal Services Department and their own Trustees for explanations of their conduct.

Another interesting anomaly arose because of the government's FSAVC review, which was not completed until autumn 2002, i.e. well after the Compromise. If the Society had cut annuities immediately after the Compromise became effective, FSAVC asset shares would subsequently have been restored by the FSAVC review. Hence the Society had to wait until November 2002 in order to be sure of cutting all the upwardly revised FSAVC fund values and annuities permanently back to suitable size along with all the others. In effect, therefore, the Society made upward revisions to FSAVCs after the Compromise which it had no intention of honouring. (Sir Howard Davies' office and the FSA were made witness to the possibility of this happening before it did, and also to the fact that the writer reserved a position on behalf of all FSAVC annuitants in this matter. This is now part of Financial Ombudsman Service complaint no. 3936405)

**12. Conclusion**

In order to cover the necessary ground, and to help assess motives and statements by comparing them to later actions and their consequences, this article has assumed an historical flavour. This has been insightful, and what has emerged appears consistent with human nature and its condition. But if human nature and condition are hardy perennials, they grow and express themselves according to the stimuli and confines of prevailing circumstances. In that these circumstances evolve and recombine, so do the human expressions, such that history does not repeat itself exactly. In this case one novel and important change in circumstance may well have been the international oil crisis of 1973. Another, which is altogether more diffuse and profound, has been a fundamental shift in *zeitgeist*, or spirit of the times. No longer do we habitually enjoy or expect the Judaeo-Christian humanitarian ethos which inspired our forefathers, and enriched us in so many ways. Its heritage includes institutions such as the Equitable Life Assurance Society. If we have to some extent forgotten our own way, we should have had no automatic right of expectation that the Equitable would remain intact, venerable though it was. Here recall the need of showing whether or not the Society's management culture has influenced the outcome.

So now it has materialised. Worse, the ensuing pattern of misdemeanours, as a whole but sometimes also in part, has beyond any reasonable doubt been fraudulent. This said, the extent to which it was fraud of the first or second degree is still unclear. The essential problem was sophistry, and there is a possibility that it began as an *ad hoc* invention in response to the 1982 Insurance Companies Act. Crucially important was an overarching sophistry to the effect that a With-Profits Fund could be run on what has been euphemistically termed a negative technical solvency gap, whereas more truly (as Richard Price and William Morgan might well have argued) that gap was a moral one. It was moreover a real one because of the Society's declared practice of paying the unconsolidated element of policies in full, such that this was policyholders' reasonable expectation. All the important dissembling, concealments and deceits stemmed from it, including the dual presentations, firstly to a select and highly sceptical actuarial forum but then not the Society in full, and secondly of the accounts, one version for members and the other for the regulator, which enabled the Society to survive for so long. As we have seen, it also led to the transition from a With-Profits Fund for old and established members to a With-Liabilities Fund for newer and future members, which in turn could not have happened unless the fund degenerated into a Ponzi pyramid selling scheme, as unquestionably it did. Hence also the need to find out from what level in the Society "incentivised ignorance" of sales personnel originated. All this only serves to reinforce the conclusion that the key trouble was not simply general mis-selling, but fraud. Marshall Field[13] had rightly said: "The new regime puts great weight on the concept of disclosure- what can be described is defensible and what cannot is suspect." The coquette who flashes a leg at one admirer and bares a shoulder for another has by no means revealed all- she may be pure wart hog in between and underneath.

Though individual actuaries had between them spotted all the big warts, their vision of the whole was less certain, and neither they nor the Government Actuary's Department appear to have articulated it. They had, however, been informed that the paradigm they faulted had been presented to and deemed attractive by an unspecified number of policyholders (R & H[8] section 2.2.3). This may have allayed their suspicions somewhat, but it also begs the question as to why, if the paradigm was so well received, it was not thereafter disseminated to all policyholders and their representatives in reasonably comprehensive form. The foregoing account implies that lack of awareness by the profession of its own history and failures of the regulatory network[7] may have contributed to this. Some might argue that the lessons of history are of limited relevance because actuarial science has moved on, and investments are more diverse and free than in the 19$^{th}$ century. But with the possible exception of investment mixing to cover and match liabilities and the ranges of age and guarantee of policies, the underlying problems were old ones such that former lessons apply. We can moreover see that the underlying sophistries were antithetical negations of history and heritage. This must be kept in mind when evaluating the line taken by the Penrose report.

We have also seen that the solvency gap arose because the Society's estate had disappeared, or was in process of doing so. Hence this is a crucial issue, and there is a need to establish whether this loss was causal and distinct, or part of a more general pattern. (It is additionally possible that overmuch of the estate had been dispensed to pre-1998 GAR policyholders, and that this lent urgency to the Society's change of course.) Members and outsiders have repeatedly been tempted to raid the Society's estate, as in 1776, 1795, 1825, 1859 and most contentiously in 1816. Price, William Morgan and his son Arthur had been much exercised to keep these within reasonable bounds[11]. It is therefore important to ask what influences around or even external to the Board and management may have operated on this final and fatal occasion, and if so why they were allowed. This must be balanced against the more innocent picture of an office which was unduly influenced by commercial and marketing considerations, and which expanded too rapidly, giving away overmuch as incentives to gain new business and incurring excessive strain in the process. It is also likely that such an office would pay more attention to the profitability of its investments than to its core responsibilities of insurance, investment safety, and certainty of outcome. But though there may be elements of truth in this, it does not excuse the Society's persistently duplicitous conduct. Nor does it explain the paradigm on which that conduct was based, or the fact that eminent actuaries in the Society's own past had repeatedly warned against this situation and that this wisdom was neglected. Human nature and institutional life being as they are, it has several times emerged that it is both unwise and unfair to call for a witch-hunt, and certainly not until it is clearer whether fraud was of the first or second degree. Even so, there must be no residual doubt as to where in the Society's organisation (or even *via* external association) the important elements of deceit arose, when they did so, and in response to what circumstances. The coherent and consistent nature of the misdemeanours does, however, suggest that when they are traced fully backwards they will have relatively few origins. Only then will there be a true perspective, and those who accepted the Compromise and those who rejected it should reserve their final positions until this has been gained and duly reflected upon.

All this we should expect from a reasonably comprehensive inquiry. And in that the governmental and regulatory milieu has hardly been exemplary thus far, the inquiry should be free to address this too in a satisfactory manner. A better understanding of the constraints placed upon the new Board of Directors and its resulting predicament should then also emerge. However, the tactfulness observed by a Lord Penrose in England may be no match for the relatively unconstrained energy of an Eliot Spitzer in the United States. And if the contemporary *zeitgeist* has also suffused governments and the regulator we should modify our expectations accordingly; in view of their past involvement both Government and Opposition may be reluctant to grab the nettle. Here also recall that the government of the day indemnified Lloyd's by special Act of Parliament before the Lloyd's Bubble burst. On one hand this is not a good omen, and on the other it may be a further disincentive to the Opposition. In such case Equitable victims and the electorate should remind Government of its responsibilities, and lay them plainly at its door. That door is at the Treasury; sooner rather than later the Chancellor must be called forth to speak.

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The J.I.A. and T.F.A are accessible and downloadable in .pdf format *via* the Resource Centre button on The Faculty and Institute of Actuaries website, **http://www.actuaries.org.uk** .

There is much more useful information available on the following support group websites, which should be visited to see what is available:

- Equitable Life Members Support Group: **http://www.cookham.com/community/equitable** or: **http://www.equitablemembers.org.uk**
- Equitable Members Action Group: **http://www.emag.org.uk**
- Equitable Life Trapped Annuitants: **http://www.cookham.com/community/equitable/elta.htm**
- Equitable Life Policyholders' Action Group: **http://elphag.co.uk**

Though the plot of this paper would have been lost by diversions into the various legal opinions, the writer has working knowledge of them. Interested readers will find them most conveniently *via* the Equitable Members Action Group and Equitable Life Members Support Group websites.

Writing this paper would have been beyond the abilities of any one person had it not been for the patiently accumulated labours and thoughts of many people. Much of it is on the websites listed above. The author is happily beholden to them all, and to those whose constant efforts maintain the sites themselves. Beyond this, he has enjoyed the help and involvement of Michael Josephs, Nicholas Oglethorpe and Peter Scawen in taking this paper through its various drafts. Its form, quality and content owe much to them. Despite their best intentions there must be imperfections- but these are the author's.

**Dr Michael Nassim**
**12 January 2004**

**Appendix I: Extracts & Comments on the Discussion of the Ranson-Headdon Paper**

**Section I: London, March 20th 1989**

Roy Ranson presented the paper in London[8]. Though more could have been taken from the discussion, the following suffices:

Mr J.H.R. Tonks among others defended the estate principle, and from him the following extracts are pertinent: "Assuming that the fund continues to accept new business, we could endeavour to reach the simplicity of the author's situation by considerably increasing the bonuses paid to the current generation of policyholders. To my mind there are two major objections to this course. First, it is inequitable to pay the present generation considerably more than they have earned. Secondly, if bonuses are artificially increased in this way the fund will attract more new with-profits business and so hasten the time when bonus distribution returns to normality. At that time the new policyholders will become disenchanted with the situation, because they have received less than their expectation. Thus I believe that, in practice, the estate will continue in being for the foreseeable future." This is, of course, a considerable understatement of what eventually materialised. He concluded: "A fifth item needs to be added to the information to be provided for a policyholder as set out in § 4.3.6. This is the relative size of the estate of the office which he is contemplating joining. That is not to say that the policyholder would always place his business with the office with the highest relative estate, and I accept that there are many policyholders who would prefer an office with no estate, once they were able to understand that such an office's bonus philosophy is in line with the authors', in that it has paid full asset share in the past and proposes to do so on future claims. Other policyholders may prefer to join an office which has a safety net of an estate, even if they realise that this has been built up by paying less than asset shares in the past, which could indicate a similar policy in future. *Whatever the outcome, I believe that they should have this information, and that it is our duty to them to devise some means of doing it."*

Mr C.S.S. Lyon reiterated the value and functions of the components of a traditional estate, as did G.K. Aslet who followed him, e.g. "…It does not seem to be difficult to explain that a mutual life office has an existence apart from the interest of those who happen to form the current generation of policyholders. This was surely the intention of the office's founders. To do otherwise seems to invite the opportunistic argument that the office should be wound up immediately so that its riches can be distributed among its members. Such a course would not appeal to those who need insurance and not a windfall profit." –and again: "… The authors also criticise the current emphasis placed on office strength, and I realise that this is fashionable. I do not want to imply that any single ratio can adequately describe the characteristics of a life office, *but its strength does have virtues beyond that of preventing the DTI intervening in an office's affairs, and there are many policyholders who might wish that their advisers had paid more attention to this point when recommending their policies.* A strong office has greater freedom to adopt the investment policy it believes will be most profitable in the long run and thus most beneficial to its policyholders. Such an office also has more time to adjust to changed conditions before being forced to take action." Again with hindsight this looks like an understatement.

Mr H.W. Froggatt concisely and efficiently summarised the issues surrounding an intrinsic mismatch of risk and reward for the different categories of policyholder in relation to the investment mix held. He began by saying that guarantees cost money, and one could meet this by appropriate charges, and/or by reducing their impact by holding a suitable proportion of fixed interest securities. The latter is also particularly important if there is no reserve estate, and so it is in the event doubly unfortunate to the extent that, in the scramble for higher overall returns, it may later have been neglected (see R. & H. section 3.2.7 & 3.2.8). H.W. Froggatt continued: "...So, for the authors' office, it seems that the total guarantees are catered for by adjusting the aggregate investment portfolio. The office, as a whole, holds investments appropriate to its guaranteed liabilities. It also exercises some control by adjusting the reversionary bonus rates. In neither case is account taken of the very different levels of guarantee being provided for policies of different original and outstanding term; nor for policies of different classes. In effect their policyholders are charged the same for guarantees regardless of the level of guarantee which applies to their policies at the time. This can leave room for selection against the with-profits policyholder in some circumstances.

Insurance operates by pooling homogeneous risks. If risks are significantly heterogeneous there comes a point at which it becomes worthwhile to distinguish the different levels of risk and to underwrite and to charge different rates of premium for them. In the context of asset allocation for with-profits business, the relevant risk element is the investment guarantee. So it is appropriate to ask at what level of guarantee it is worthwhile to abandon the simplicity of the authors and differentiate between policies with different levels of guarantee?"

And in his conclusion he stated*: "The simplicity described in this paper has its price; and existing and new policyholders - and their advisers, if they have any - ought, in the present climate of disclosure, to be made aware of what these might be".*

**Section II: Edinburgh, 19th February 1990**

The Ranson-Headdon paper had a second outing the following year on the 19th February at the Faculty of Actuaries in Edinburgh[10]. In introducing it Christopher Headdon took the opportunity to explain the latest developments, and to attempt to dissuade the meeting from discussing the estate issue in so much depth as previously in London. He began by saying that at the end of 1989 the market value of the Fund assets stood at around £5,700 million and that after the transfer of appreciation to revenue to support the bonus declaration the "investment reserve" amounted to about £1000 million. How much of the latter was accrued unconsolidated benefits and how much was remnants of the previous estate was not explained. Significantly, he went on to say that a further development to the bonus system had been made: "Paragraph 3.2.18 of the paper foresees the development of the business so that total policy proceeds, that is the sum of consolidated and unconsolidated benefits, steadily accumulates from year to year in a way which would enable published final bonus scales to be done away with. Such an approach is consistent with our general philosophy in that we consider all business of whatever term or duration in force to experience the same uniform asset mix.

At the time of writing, we had seen this development of our bonus systems as a possibly long-term development. However, circumstances have changed, and we find it desirable to make such a move sooner rather than later. Accordingly, the new approach was introduced in respect of 1989." And a little later: "Our recurrent single premium business is, effectively, equivalent to unitised with-profits business. Since most unitised with-profits business is fairly new, the terminal bonus element in policy proceeds is not yet very significant, and most offices appear to be taking a fairly straightforward approach to this part of total proceeds.

<u>By contrast, we have been selling such business since 1956, and have substantial tranches of business which have been in force long enough to have attracted a sizeable final bonus element. Arriving at an approach which deals with the unconsolidated element of total benefits in an equitable manner, in the face of a very wide degree of variability in the timing and amount of premium payments, is, we feel, a problem which we have encountered in advance of most offices. It would be interesting to learn if actuaries with offices now writing unitised with-profits business have different ideas of how to cope with terminal bonuses when the business becomes more mature</u>." All too evidently the Equitable never solved this problem either, and ended up with unreal bonuses that crossed over into genuine liabilities.

Headdon then went on to say that there was not one myth of estate, but two: " The first myth is that all offices have an estate, in the sense of a body of assets which belongs to no-one……….. The second myth is that by having an estate, an office's policyholders are much better prepared than if no estate exists. If one has an estate, then it seems to us that one of two approaches can be taken. The first is that the estate really is a cushion that is available if the need arises. The second is that it is money held in a kind of trust, to be maintained and passed on to future generations.

If the first of those approaches is taken, then additional protection is available on a one-off basis for one fortunate generation of policyholders. However, once used, the estate ceases to exist and the office moves to our position.

In the second case, the estate cannot be utilised except for some temporary additional smoothing, since it would otherwise not be preserved for the future. <u>In that case, are policyholders really better protected? Indeed, should not product particulars state that the office's policy is to maintain an estate of x% of assets, and that a charge of y% on the investment earnings otherwise available to policyholders will be made in order to support that policy".</u> The sophistry in this passage is so obvious that it needs no formal explanation, and in the underlined portion Headdon has begged the question as to how the Equitable's own approach should have been put to its representatives and policyholders. In the event, of course, that explanation never materialised.

In opening the discussion Mr S.T. Meldrum said: "The paper is not a rigorous mathematical proof of a new actuarial principle. It is a clear and straightforward description of a bonus philosophy tinged with pragmatism. We must thank the authors etc". He also declared a natural sympathy with the approach taken in the paper, because he had qualified at the Equitable. His position was therefore more informed than most, and he stated it thus: "The authors in paragraph 1.1.1 find themselves frustrated at industry obfuscation in the form of resistance to un-bundling of expenses and an emphasis on "strength". They find their escape in borrowing some of the concepts of unit-linked insurance and applying them to the with-profits contract and in particular to one form of that which makes up the bulk of their office's business, a form of recurring single premium with-profits pension accumulation policy.

Each premium paid secures a slice of the fund calculated by accumulating the premium less expenses at a guaranteed accumulation rate of 3.5% (i.e. the Guaranteed Interest Rate or GIR) to the chosen pension date. Effectively this is the "sum assured" of the policy. Reversionary and terminal bonuses are declared on this sum assured with the intention of returning full value to the policyholder at his pension date, but with a "smoothed" investment return.

<u>Since 1987 results have been shown to policyholders additionally in present value form and for new contracts such as personal pensions this is the only form.</u> The contract is then effectively a unitised with-profit. The authors in paragraph 3.2.6 define the policyholders key concern in bonus declaration as the total proceeds with the question as to how much can be declared and how much to emerge as terminal bonus as of secondary importance. The increasing guarantee given by declared reversionary bonuses is however central to with-profits business.

In paragraph 3.2.15 the authors describe how the final bonus lifts the declared bonus to an appropriate asset share subject to averaging and smoothing. The smoothing occurs two ways: firstly over durations at that point in time, and secondly over time.

The essence of smoothing is insurance of the investment risk. It is a system which has inherent appeal but I have some practical difficulty with its application.

My first problem relates to the smoothing over time of an investment risk whose first move is downwards. It does not appear possible to do this within the ordinary understanding of prudence unless there is some other source of capital available. This appears to have been the situation described in Appendix A for the triennium ending 31 December 1976. The situation was then met by releasing unnecessary margins in the valuation basis. It is in this sense that I describe the approach in this paper as one of pragmatism rather than one of rigorously proven theory.

It is in the area of policyholder's self insurance of investment risk that I believe a lot more could be done to make the techniques more scientific. A life company can self-insure mortality risks with the experience, good or bad, reflected in the returns to with-profit policyholders. But to do so it must have some measure of the expected risk to be charged initially to each policyholder and on the basis of which the subsequent experience is then spread. This is the principle of equitable assurances. I cannot see a corresponding principle of equitable investments described here.

How sure are the authors that the averaging over contracts fully reflects the risks of those contracts? How sure are the authors in averaging over time of where the market then stands? Hindsight is a great help, but without it the consensus of all the players in the market is that the next move is as likely to be down as up. The market reflects all that is known. I would like to hear more on how the authors improve on this.

The process of an increasing level of guarantees under each policy as bonuses are declared while the totality of policies still participates in the investments underlying the whole fund is one whose pricing basis lies in option pricing theory…Although the practical difficulties may be large I recommend that some thought be given to this because it is in this area that I am least comfortable" Here S.T. Meldrum seems to be making much the same points as H.W. Froggatt had previously, although starting from the analysis of risk rather than from guarantee. The underlined portion is now important in terms of what should have been disclosed in view of how matters were actually represented, as well as to whom.

Also relevant to issues of disclosure was his conclusion: "The authors have done us a great service in exposing these issues and there is a lot of material here which those present can use to compare with the philosophy of their own offices. I would like to think that more offices would be encouraged to expose their philosophy in this manner. *I look forward at least to reading a mini version in the many company booklets which are shortly to be produced".*

Mr P. Kilgour provided a comprehensive and well-balanced overview of the situation. The following extract from his commentary is relevant to the vexed question of guaranteed versus unconsolidated benefits, and what the corresponding duties of information might be: " The authors suggest that with-profits policyholders expect to receive policy proceeds on maturity broadly equal to those that would have been achieved under a unit-linked contract invested in a balanced managed fund. *I wonder whether all policyholders would agree on the investment mix in a balanced managed fund. A lack of clarity about the target at which they think their with-profits contract is aiming is likely to result in confusion.*

*The balanced managed fund against which they should be comparing is one which is appropriate given the guarantees in the contract, and any attempt to describe an appropriate portfolio of investments for a with-profits contract must include a comment on the relevance of the guarantees.*

*The significance of these guarantees is substantially reduced if declared bonus rates are at a level financed by only a fraction of the full investment return being achieved. The authors do not say so but I wonder if they are suggesting that in future, policyholders can expect that, whether there is inflation or not, declared bonuses will be at a level financed by a fraction of the investment return achieved- thereby creating a continuance of the current picture for maturities in that a substantial element of the maturity payout will be in the form of a terminal bonus. This seems in concert with their claim that with-profits business is a source of capital- in fact I do not see how it is unless such a bonus policy is pursued.*

*The forthcoming statements on bonus philosophy will probably contain a relatively detailed explanation of a company's current stance but will not tie the company to a continuation of that stance. Over the duration of their contracts, policyholders will be able to gain access to up to date statements on bonus philosophy and will be free to make their views known to the appropriate parties should any changes not meet with their approval."* To this one can only say: "Amen, and if only!" Mr Kilgour also supported the role and value of a "dowry" or estate in the usual ways, and explained his own preferences for adopting an appropriate investment mix based on duration elapsed and term to run, and which also reflected the level of guarantees.

Mr W.B. McBride spoke as one whose office had strong parallels with the authors' as a non-commission paying mutual, the major part of whose business was also single premium with-profits, which had been growing rapidly in recent years. However he continued:

"Our trading experience, however, as is public knowledge, has been rather different.

Again until recently, my office would probably have subscribed, although more subconsciously than the authors, to their view of the mythical nature of the rationale of the estate, even of its existence.

We would not hold that view today. Instead, we recognise the estate as a precious attribute of the office, inherited from the past, yes, but to be husbanded, and handed on to future generations of with-profits policyholders. We would recognise the estate as the difference between the value of the assets and of the published liabilities, plus the present value, at the required rate of return, of the future stream of profits from the business (other than profit attributable to policyholders). This measurement should reconcile with the difference between the value of the assets and the total of the asset shares of current policyholders.

We would not consider the fact that various methods of making these measurements exist, so that the size of the estate at any moment is not an absolute and precisely measurable quantum, as any barrier to accepting its reality. As to its rationale, our experiences have reinforced the view, held by many actuaries, that the estate is of benefit to the current generation of policyholders in a number of ways, notably the power it conveys to the office to smooth out the effect of fluctuations in the equity markets.

Given that shares now change hands every hour of the 24 somewhere in the world, and that there is instantaneous reaction to news good or bad, smoothing power has never been more important.

Where there is no estate, and the investment reserve represents the unconsolidated earnings attributable to current policyholders, one would expect terminal bonus rates to be rather more volatile than I believe has been evident in the declarations by the office of the authors. <u>I immediately dismiss as unworthy the suspicion that perhaps they do not know their own office's strength</u> …….

…..We do not claim that our asset share calculations represent precise reality- they could not hope to in practice and ought not to in theory, or the process reduces to unit linking- but we believe that their relativity to one another is valid. The process implies, of course, a significant degree of smoothing which has recently been made practicable again for us by virtue of becoming backed as a sub-fund of an international mutual, by a powerful estate.**"** The omitted intervening section echoed previous observations on risk, liability, asset matching and bonus distribution philosophy. Alas, the underlined statement proved all too worthy in the event; the only argument now being over how much was hubristic ignorance and how much was concealment.

Mr C.E. Barton agreed with the authors over the estate issue, but may have been mistaken in observing: "I very much like the author's preference for the term "non-consolidated assets" rather than the somewhat mysterious term "the estate". When Redington coined the word "estate" in 1952 he was much more concerned with solvency than with the equitable management of a participating fund. Twenty nine years later, against the background of "The Flock and the Sheep", Redington's concern was with "non-consolidated assets" rather than what has been called an "inviolate estate"". Did he realise that this included the liability estate, or that the "asset estate" might come to exist only in notional form as unconsolidated and unsupported bonus statements?

Mr M.D. Ross was under no such illusions. He said: "There is very much in the paper with which I agree and which reflects my own views on bonus policy. However, there are some points brought out in the paper with which I disagree; I think they are based on what I would term as too serene a view of what future conditions might bring…

…Recognition must be given to the likelihood, at some time or another, that the underlying pro rata asset shares will fall below guaranteed payouts and some charge must be retained for this- logically it would vary with policy term.

While reference is made to the pooling of investment mix I do not see this point emphasised in the paper. I see it as important, very important unless the non-guaranteed element can be set very high- perhaps at levels currently applying for long-term policies. However, as I have said on other occasions, it is rather difficult to see such high targets reflected in current reversionary bonus declarations/unitised with-profits price increases.

This leads me on to the section entitled "the myth of the estate." Having done stochastic modelling it is not difficult to see the need for some free assets, certainly with the current valuation regulations. Of course the authors refer to the unconsolidated element of policyholders' asset shares as being available to meet finance strains and guarantees. However again the average duration of an office's business is important and an office's ability to keep the unconsolidated element alone high enough at all times to guarantee survival in a wide range of financial conditions has to be challenged. <u>**Free assets are likely to be required over and above the unconsolidated bonus element…..**</u>

…In paragraph 3.3.5 reference is made to the nature of the guarantees and its relevance in the context of product design. Examples are given of full value guarantees at a range of retirement ages, e.g. 50 to 75. Interpretation of Regulation 62(2) in its strictest sense is likely to prove very severe in terms of reserving requirements over time, again stochastic modelling is likely to indicate that an office could not demonstrate statutory solvency over time without very considerable free assets- yet the authors eschew the need for this. Something must be wrong. It may be that it is envisaged that the terminal bonus element will always be maintained at a very high level, but of course in these circumstances the granting of a full value guarantee is not particularly meaningful. I raise this, not particularly to take issue with the authors, but more because we have found in our own modelling that a strict interpretation of Regulation 62(2) can prove very severe for pension contracts. I would be interested to know whether any other Appointed Actuaries would assume all policyholders within the guarantee period would retire immediately or if, what I would call, a more realistic view of this can be taken in practice." Mr Ross was right; something was indeed wrong.

More could be quoted from these discussions, for example the contributions from A.D. Shedden, W.A.B. Scott, and A. Eastwood. Scott, who gave qualified support to the authors' concept of the myth of the estate provided that adequate financial strength was otherwise maintained, also entered the following caveat:

*"I think we can agree that it is this modified version of the managed fund concept which has to be communicated to policyholders if the mystery of with-profits business is to be dispelled. On this front the authors may be ahead of most of us, assisted no doubt by the simple nature of the majority of their contracts and by the absence of intermediaries in their dealings with policyholders. Clearly there must be a risk of raising unreasonable expectations if communication of this nature is not carried out with due care and attention but on balance I am sure that this is the road down which we must go"*

In view of subsequent events, this opinion suitably concludes the Appendix.

**Appendix II:** Extract from Ogborn, M.E.[10], p206-7.

"A contemporary view of the Society's affairs is given by Augustus de Morgan in *An Essay on Probabilities* (1838), one of the volumes in "The Cabinet Cyclopaedia".

I always consider (the Equitable) Society as a distinct and anomalous establishment, existing…under circumstances of an unique character. It is the result of an experiment which it was most important to try, but which, having been tried, need not be repeated…The hazard having been run, and having turned out profitably, the proceeds belong to those who ran it, and to those who, by their own free consent, became their lineal successors. Nor is it the least remarkable circumstance connected with this Society that the immense funds at its disposal have always been opened, though under restrictions, to the public… The general lesson taught by it (the history of the Society) is- be cautious; but…be cautious of carrying caution so far as to leave a part of your own property for the benefit of those who are in no way related to you. If there be a Charybdis in an insurance office there is also a Scylla: the mutual insurer, who is much too afraid of dispensing the profits to those who die before him, will have to leave his own share for those who die after him. Reversing the fable of Spenser, we should write upon the door of every mutual but one *be wary*; but upon that one should be written *be not too wary* and over it *Equitable Society.*

Clearly, Augustus de Morgan thought that too little bonus had been declared and too much surplus had been held back for the future. In this he was probably misled either by the size of the rapidly accumulating funds or, as seems more likely, by the increase in the *rate* of bonus at successive decennial distributions to the magnificent rate of 3 per cent per annum in 1829. However, this takes no account of the effect of spacing out the distributions to ten-year intervals and the figures already quoted for claims under assurances which had been forty years in force do not support his opinion (£390, £380 and £381 for assurances of £100 effected in the years 1770, 1780 and 1790 respectively).

The relatively high prices of Government stocks at this time gave an appearance of great prosperity but, in fact, the outlook had been worsened. The immediate surplus had been swollen but the margin for future surpluses had been lessened. The position would have been serious but for the use of the antiquated Northampton table- which overstated the liabilities- and the reservation of one third of the surplus.

Actuarial opinion, too, would not support Augustus de Morgan's argument that the funds of a mutual society belong exclusively to the members of the fund at the particular moment of time. A mutual life assurance society is a continuing business. Ample funds are necessary for the credit and stability of the office and each generation of members comes into a heritage from the past; so in its turn, each generation should endeavour to pass on that heritage unimpaired to the generations that succeed it. William Morgan understood this and modern opinion would support him.

Augustus de Morgan's view of the Equitable as a unique institution, whose practices should not be adopted by other societies, was related to the rigid, inflexible methods into which the Society had been forced*. Experience has shown that more flexible methods are desirable and the whole subject is now better understood. But the principles of mutual life insurance, with the policyholders sharing in periodical bonus allocations, are part of traditional practice in the United Kingdom and in many parts of the world; these were taught by the "experiment" of the Equitable Society."

*These were the results of previous compromises struck by the Court of Directors and the Actuary with the membership. In effect they were the sum of attempts to balance the interests of older versus newer members, and reconcile them with the needs of the Society as a whole to continue in business or expand judiciously. As a result the Society became relatively unattractive to new entrants in the middle of the 19th century, and a period of stagnation ensued, essentially for the reasons given at the end of Section 3 in the main paper (MN).