

**EVALUATION FOR ELTA OF THE PENROSE REPORT:
STATUS PRECEDING THE COMMONS DEBATE
ON MARCH 24TH 2004.**

In January 2004 the ELTA website made advance provision of an account of what went wrong at the Equitable, the wrongs suffered, and the grounds for what needs investigation. Hence we can with ease add new relevant findings to it, or draw attention to matters outstanding in comparison with other reports. Though the Penrose Report (PR) is long and detailed and the time to study it has been short, in summary we can presently say:

- As expected, in his introductory letter Lord Penrose has been obliged to qualify the terms and scope of his inquiry. He had no formal powers, could not compel submissions or attendance, undertook to observe confidences and has not wished to compromise ongoing legal proceedings or tribunals.
- The PENROSE REPORT's forensic accounting over the period 1970-2001 is very helpful and insightful, because it presents the salient developments in both narrative and tabular form. It broadly corroborates Burgess Hodgson's prior evaluation of the period 1990-2000, and provides important new information.
- Prior to the inflationary 1970's gilts were a traditional safe haven, and the Society had not fully embraced the cult of equities. Servicing of its liabilities was based on interest earned from gilts, etc. It was very cautious about how to account for equity capital appreciation of its investments, and distrusted the inherent volatility of share valuations. Hence it was not initially disposed to regard such appreciation as a real asset. But after Maurice Ogborn retired in 1972, Sherlock & Ranson allowed 10% of this appreciation onto the books in 1973. But in 1993, after the introduction of the Insurance Companies Act, 100% of capital appreciation was allowed.
- 1973 was also the year in which Sherlock & Ranson introduced the "three call system" to allocated the surplus income generated by the equity component. Equity earnings were supposed to go three ways:
 - 1) As an equivalent amount to the yield of a comparable capital holding in fixed interest securities.
 - 2) A positive or negative adjustment to compensate for any difference that resulted, and
 - 3) Allocation of excess positive adjustment as terminal or reversionary bonus. In practice, because of recurrent pressure to allocate bonus, negative adjustments to the second call were usually not made good, and the "three call system was abandoned in 1984.
- A significant new finding in the Penrose Report is that the Equitable had commenced building a strong sales function to offset the gap created by the disappearance of the Federated Superannuation Scheme for Universities shortly before the 1973 oil crisis emerged. It was thus committed, and adhered to, expansion at a time when rapid capital depreciation of its equity holdings resulted. This capital loss accounted for virtually the whole of the Equitable's accumulated estate, and it is arguable that it was never again properly restored.
- Though it does not say so directly, the PENROSE REPORT implies that the Equitable did not fully appreciate the increased volatility of its equity portfolio, or the fundamentally inverse relationship between inflation and interest rates. By the same token, the PENROSE REPORT account would be much strengthened were it adjusted for monetary inflation and the explosive growth in sales. This would make the underlying financial weakness and the failure of reserves to increase *pro rata* more insightful.
- It might therefore be expected that the large new sales tail would wag the dog in various ways, e.g. development of a sales-orientated culture, higher fixed costs, and an inevitable drive to maintain and increase sales (e.g. by over-bonusing), which could become an end in itself and steadily erode financial strength. The PENROSE REPORT shows that effectively this is what happened.
- If so, there is a need to investigate the influence of the sales and marketing function on the Equitable's business policy, and any active contribution it may have made to actuarial policy as defined in the "With Profits Without Mystery" approach at executive or Board level. Conversely we need to know why the important details of this approach did not come through in sales literature, product particulars and contracts, and why branch offices and representatives remained in

ignorance of them. However, an internal commission was paid to sales staff. "Incentivised ignorance" of sales staff remains an outstanding issue.

- Remarkably, the PENROSE REPORT makes no reference to the With Profits Fund degenerating into a Ponzi pyramid selling scheme, or the similarities between the Equitable Bubble and the Lloyd's "recruit to dilute" campaign.
- As might be expected from its limited remit, the PENROSE REPORT is much stronger on prudential and regulatory aspects than the conduct of business as governed by the Financial Services Act (1986). This is apparent in four ways, viz:
 1. it says little about the evidence presented by individual policyholders.
 2. Analysis of the With Profits Without Mystery (WPWM) manifesto is centred upon financial strength rather than Policyholders' Reasonable Expectations (PRE), inequities of guarantee or duties of information.
 3. It does not open up the issues of misrepresentation, negligence, maladministration, mis-selling and fraud.
 4. Notwithstanding the fact that the Financial Services and Markets Act (2000) did not give the FSA statutory responsibility for insurance and conduct of business regulation until December 1st 2001, there is little criticism of the FSA for its omission to supervise conduct of business by the Society prior to that date.
- The PENROSE REPORT does not examine the WPWM manifesto in relation to the Society's history prior to 1970, and so does not reveal that it is in essence a series of sophistries, which are antithetical denials of lessons previously learned. Nor does it stress the coherence, consistency and duration of the wrongs that resulted.
- It is therefore a matter of concern that one of the creators of WPWM, who may have owed feudal allegiance to Ranson, ran the Systems and Controls Review Group (SCRG), the purpose of which was to manage risk and counter fraud, and that Ranson maintained that SCRG's responsibilities were executive, and not a Board matter. The PENROSE REPORT has specifically examined the executive roles of Ranson, Headdon and Nash, but feudal allegiances and management culture in the actuarial, sales and marketing functions may deserve further general consideration.
- Management culture may be relevant to why actuary Andrew Soundy made no headway with Headdon and Ranson when protesting the unfairness of the GAR Differential Terminal Bonus policy in 1994. Conversely, it may also explain why Soundy could take over risk management and report to Julian Hirst after SCRG was disbanded in 1999 (Ranson having retired in 1997).
- It is also a matter of concern that besides risk management and SCRG, product design and the entire WPWM concept were executive matters into which the Board of Directors had no real input. Lack of relevant expertise in the non-executive directors was a material contributory factor.
- It is therefore not surprising that Lord Penrose should later say that the Society (presumably as a whole) was a victim of its own propaganda. But this does not explain the origins of propaganda, or why an influential minority with crucial knowledge formulated the propaganda.
- Lord Penrose's remit has not permitted him to say much about the harm done to policyholders, either collectively or individually. He estimates that the Society was short of 4.4 billion pounds in 2000/1. This estimate does not include restoration of estate or reserves, nor does it include:
- Liabilities for residual inequities of guarantee, and most notably the GIR issue.

Conclusion: Though the constraints upon Lord Penrose may disappoint those who hoped his Report would be more positively judgemental, it is a substantial and informative work. It adds much relevant supportive detail to relevant lines of investigation. But it remains important for groups and individuals to stress why the Report has not been able to address misrepresentation, maladministration, negligence, mis-selling and fraud in their correspondence with the Financial Ombudsman Service, the Serious Fraud Office, FSA and

regulators. The E7 group will also need to make the case for mis-selling and fraud in their negotiations with the New Board of the Equitable, and in their various law suits.

Given this situation, Treasury Spokesman Ruth Kelly's assertion that Lord Penrose's findings rule out compensation for regulatory failure is inappropriate. The Chancellor of the Exchequer should be asked for a statement if the Parliamentary debate of March 24th results in stalemate.

Dr Michael Nassim. March 24th, 2004.