Did anyone learn anything from the Equitable Life?

Lessons and learning from financial crises

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Few businesses have 250th anniversaries. 250 years spans half the 500-year existence of the business company. It is five times the 40 to 50 year life expectancy of Fortune 500 corporations. It is twenty times the 12.5 years average lifespan of firms, irrespective of size, in Europe and Japan.[1] Although life assurance firms tend to be longer lived than others, because of the long-term nature of their liabilities, many disappear through acquisition, as well as, occasionally, insolvency. A 250th anniversary is certainly a notable milestone.

When Equitable was established in 1762, the industrial revolution was just beginning. The two-and-a-half centuries of Equitable's lifespan have been an era of economic growth and transformation unique in the history of mankind in which an expanding and unprecedented number of people have enjoyed higher living standards. Prosperity brings greater need for financial services, with the provision of life assurance and pensions contributing to the enhancement of welfare. However, Equitable's most recent decade-and-a-half has been dreadfully troubled. Thus Equitable's milestone is an occasion which is, as chairman Ian Brimecome puts it, 'to be marked, not celebrated'.

The Equitable Life crisis, which began publicly in the late 1990s, was the biggest crisis in the modern history of British insurance and pensions. Unsurprisingly, it generated extensive press attention, a variety of inquiries and copious reports on what happened and who might be blameworthy. This further report draws on this literature. By way of introduction, it presents an outline of Equitable's historical development and crisis based on a range of written sources, particularly the reports on Equitable by Ronnie Baird (2001), the FSA's internal auditor, and Lord Penrose (2004), a judge, and conversations with informed individuals. It is certainly not the intention to be drawn into past or continuing controversy regarding rights, wrongs or injustices. The focus of this report is what lessons might potentially have been drawn from Equitable's crisis and what was learned, and how they related to the subsequent financial crisis of 2007-08.

The Equitable Life Assurance Society

Pioneer of scientific life assurance

Equitable originated the role and title of 'actuary'

'Shed a tear for the passing of the world's oldest mutual life assurer,' declared 'Lex' in the *Financial Times* on 21 July 2000, reporting a House of Lords legal ruling that resulted in Equitable Life being immediately put up for sale.[2] The judgment was the unexpected culmination of the legal process initiated by Equitable seeking court backing for its differential bonus policy. But why was the illustrious 238-year-old institution in trouble?

The Equitable Life Assurance Society was established in London in 1762 by twenty-one subscribers, who were both policyholders and owners (members).[3] It was not the earliest life assurance provider, the Amicable (1706), London Assurance (1720) and Royal Exchange Assurance (1720) were forerunners and competitors. Equitable's claim to fame was as the pioneer of scientific life underwriting.[4] Its business was based on path-breaking actuarial studies by James Dodson, a fellow of the Royal Society, who, rejected as a member by the Amicable, was one of Equitable's promoters.[5] Indeed, Equitable originated the role and title of 'actuary' – the mathematical experts whose life expectancy calculations underpin modern life assurance. Dodson's calculations allowed Equitable to offer lower premiums than other hit-and-miss life assurance providers. By accepting only healthy applicants in non-dangerous occupations, Equitable positively selected a membership who out-lived Dodson's mortality projections, making the business even more profitable than anticipated and allowing reductions in premiums that attracted new policyholders.[6]

A further favourable factor was the very low prices of British government bonds in Equitable's early years due to war, which allowed it to build a £4.7 million portfolio of gilts (90 per cent of assets) shortly after the battle of Waterloo in 1815.[7] With the coming of peace, the price of gilts soared (in 1822 the portfolio was worth £7.2 million) triggering a rush of applications to open policies to become members to participate in the windfall. In 1816 the existing members decided to limit the payment of bonuses to the first 5,000 policyholders (themselves). The 'restriction' had important consequences for Equitable and, arguably, 'altered the whole course of life assurance history' by having the effect of encouraging new entrants to the industry.[8] At the time of Waterloo, the British life assurance industry nationally comprised some ten offices, with Equitable one of six London offices. Equitable's Midas-like success inspired the establishment of a swarm of new life assurance offices; by 1830 there were 51; in 1870, 110.[9] Equitable's membership, on the other hand, peaked at 10,000 in the 1820s, but then declined relentlessly to 3,800 by 1870, and the business stagnated. The death in 1892 of the last members assured before 1817 allowed the adoption of a new constitution the following year that removed the restriction on bonus payments. New management was recruited that successfully revived Equitable's business, which had somehow retained its esteemed brand, introducing new products that soon included pensions.

Pension business development

The foremost purpose of life assurance was to provide a payment to the widow or other dependents of a deceased bread-winner. As society became more prosperous life expectancy lengthened, making a period of life after work a possibility for a growing number of people. Hence to provision for dependents upon death was added provision for a bread-winner's retirement – a pension. Pension provision for middle class professionals, for instance, lawyers, doctors, businessmen – a fast expanding social group with disposable income for saving, but without the protection of inherited land or fortunes – developed from the late nineteenth century. Equitable

By the early 1970s Equitable had developed no fewer than 250 different pension schemes

A 'standard feature'...was an option to obtain an annuity at a guaranteed rate

The guaranteed rate was well below the level of market annuity rates in the high inflation 1960s, 1970s and 1980s so the option was little exercised

Group scheme clients included a clutch of blue-chip companies, the National Health Service, the Post Office, the parliamentary pension fund

introduced its first pension product in 1902, an early life assurance linked scheme.[10] The Society focused on provision for 'top-hat' clients; policyholders including novelist John Galsworthy, cricketer W. G. Grace and Prime Minister Neville Chamberlain.

In 1957 Equitable introduced an innovative new flexible with-profits pension product for the self-employed, the Retirement Annuity Policy, described by Penrose as 'a contract form with a range of core features that readily lent themselves to adaptation to changing market demands'.[11] It was developed by Maurice Ogborn, 'an actuary in the historic mould, highly regarded and innovative' (Penrose), Equitable's general manager and actuary from 1967 to 1972 (and author of the firm's bicentennial history published in 1962). By the early 1970s Equitable had developed no fewer than 250 different pension schemes in pursuit of policyholders in the increasingly competitive life assurance business.[12]

A 'standard feature' of Ogborn's pension product was an option to obtain an annuity at a guaranteed rate – a Guaranteed Annuity Rate (GAR).[13] The guaranteed rate was well below the level of market annuity rates in the high inflation 1960s, 1970s and 1980s so the option was little exercised. Life assurance was highly competitive with providers vying for business by offering attractive product features.[14] GARs were 'common' throughout the life business – 40 life companies offered such an option in the 1970s and 1980s – but the 116,000 such policies written by Equitable were a 'much bigger' proportion of its business than with other companies.[15] Equitable removed the GAR option with the advent of personal pensions in 1988, but existing policies retained the feature.[16]

From the early twentieth century, employers provided pensions for staff in the form of group pension schemes managed by insurance companies.[17] Equitable was appointed manager of the Federated Superannuation System for Universities (FSSU), the scheme for university teachers, which was launched in 1913.[18] In following decades FSSU was Equitable's biggest client, accounting for half of its total pension business in the 1960s.[19] Penrose commented that the contract 'required little in the way of marketing and management, and was of its nature aimed at an intelligent and articulate clientele. This appears to have insulated the Society from general competitive pressures.'[20] Operating from offices in London, which undertook investment and general management, and Aylesbury, the centre of actuarial administration, he characterised the business at the start of the 1960s as 'a small, conservative, with-profits life office'.[21]

The alarming prospect of losing the FSSU contract owing to future government pension reform stirred Equitable's management into action, setting its sights on growth. In 1963 it adopted an active marketing strategy, which led to the opening of new branches and the development of its sales force.[22] On the investment side, the early 1960s saw a late debut in equities. 'Initially aimed at replacing FSSU business, sustained growth became an independent objective with something approaching missionary zeal and with the conviction that the Society had a unique range of products and offered a unique level of service to its target clientele of high-value policyholders,' commented Penrose. 'The pursuit of growth came to characterise marketing policy from the mid 1960s until the late 1990s.'[23] The drive proved highly successful and by the late 1990s Equitable had a million-and-a-half policyholders and was one of Britain's three biggest pensions providers. Group scheme clients included a clutch of blue-chip companies, the National Health Service, the Post Office, the parliamentary pension fund, and the Personal Investment Authority.

Upon Ogborn's retirement in 1972, there was a generation shift in Equitable's management. Barry Sherlock became general manager and actuary, with Roy Ranson as deputy actuary. The new management team was challenged not only by the loss of FSSU business, which waned from 1970, but also the onset of financial market turmoil with the quadrupling of the oil price in 1973, a severe recession, a stock market crash in 1974 that played havoc with solvency, and rampant inflation that hit 24 per cent in 1975 when Equitable's GAR rate was raised to 7 per cent.[24] Up to 1972, Equitable, like other life assurers, had maintained substantial accumulated reserves of free assets, known as an 'estate', as a capital buffer in case of commercial adversity and to facilitate the smoothing of with-profits allocations to retiring policyholders.[25] For one reason or another – Penrose mentions 'adverse market conditions', but also 'policyholders being given benefits earned by their predecessors' – between 1973 and 1976, Equitable's estate was 'exhausted'. [26] In following years free assets were re-accumulated, but then from 1983, the estate was again run down in accordance with the society's new 'philosophy' of 'full distribution'. [27]

A risky business model

Traditionally, the leading life companies had maintained a gentleman's agreement ceiling on commission rates that could be offered to third parties – insurance brokers, independent financial advisors (IFAs) etc. – who sold their products. But in 1983 this broke down because of the entry into the market of thrusting new providers that refused to be bound by the convention.[28] An industry attempt to restore the cap on commissions fell foul of the Office of Fair Trading as a restraint of competition and commercial pressure intensified.[29] Sir David Walker, a leading City banker, deputy chairman of the Securities and Investment Board, forerunner of the FSA, as well as deputy chairman of Legal & General, recalled being told by Barry Sherlock that Equitable would have to improve the terms of its policies to remain competitive.

During the 1980s, Equitable developed a business model distinct from the rest of the life industry. It had several interlocking features: an up-market customer base; its own sales force; low costs; mutuality; and 'full distribution' of investment returns to policyholders. Equitable's business model delivered growth in business volume and pleased policyholders during the 1980s and 1990s, but it proved to have dangerous flaws.

'Equitable was a kind of insidious operator,' said the *Daily Mail*'s Alex Brummer. 'It got into your organisation and spread out like algae across the sea. It got into a building, got to one person and before you knew it they were in everyone's offices selling policies. It was kind of a cult and exclusive. It was full of lawyers, doctors, MPs, journalists. There was a certain elitism about it – "we're not like those other insurers, we're different." When they sold you a policy they made you think they were letting you in on a secret, doing you a favour, letting you into this 230-year-old society.'

Equitable policies were marketed directly to clients by its 400-strong sales force. Before the crisis, they averaged annual premium sales of £6 million each – 10 times the level achieved by rivals – and top performers earned more than £100,000 a year. 'One of our salesmen could sell a policy to a barrister at Lincoln's Inn Fields and end up selling one to every other barrister in that set of chambers,' said an Equitable adviser, while competitors 'were slogging round housing estates in Swansea. There was really no comparison.' [30] 'The Society marketed on the basis of high levels of service provided to policyholders, both in terms of the highly flexible products on offer, and in terms of ancillary financial and tax advice provided,' observed Penrose calling it a 'distinctive feature.' [31] 'As a nascent regulator, I thought not paying commission was, and I still strongly think is, best practice,' commented Walker. 'People had a view of Equitable as covered in a white sheet. I mean, they were virtuous, they had good practices, they were seen as a model.'

Having its own highly-productive sales force checked costs through the absence of payment of commission to third parties. Mutuality also saved costs, since there were no dividends to shareholders as the owners were the policyholders. Penrose noted that Equitable's 'consistent emphasis on low expenses, in absolute terms and by comparison with the industry' was a further 'distinctive feature'. Moreover, Equitable invested heavily in IT, and had the best life and pensions administrations systems in Britain – perhaps the world.[32] On the back of this it developed a thriving consultancy business. Low costs and business efficiency contributed to high bonus payments to policyholders, which helped the salesmen win new business. 'Why were the doctors and the dentists and the lawyers and the judges all in Equitable?' said Angela Knight, former chief executive of the British Bankers' Association and former non-executive director at life assurer Scottish Widows. 'Because it gave the biggest return.'

But a key reason for Equitable's regular appearance at or near the top of the life industry's performance league tables was the distinctive policy it pursued from 1983 of 'full and fair distribution' of each year's investment returns (less the amount necessary to meet liabilities and satisfy legal solvency requirements). [33] The adoption and pursuit of the 'full distribution' policy as a response to the 'highly competitive market' (Penrose) was closely associated with Roy Ranson, who became Equitable's

...the unique way they ran the business meant they could never afford to make any mistake

The 'mistake' emerged in October 1993 – falling inflation and interest rates led market annuity rates to dip below Equitable's guaranteed rate for the first time

joint actuary in 1982 and was chief executive in 1992-97.[34] Equitable's 'philosophy' of the 'members' ownership of the business' was articulated by its actuaries Roy Ranson and Chris Headdon in a paper *With Profits Without Mystery* in 1989, which received, reported Penrose, a 'mixed response' among the actuarial profession including 'polite expressions of disagreement and disquiet'.[35] 'Equitable's practice meant that there was no holding back of profits from one generation of policyholders to the next,' Baird explained. 'This had the effect of increasing the returns paid to policyholders and was a strong selling point for Equitable Life. It was a "source of pride" to Equitable Life which had claimed that it had always sought to pay out the highest amounts when policies became claims (whether at maturity, death or surrender).'[36] 'This approach, and the absence of a free estate, was presented as being a continuation of an approach that dated back to the establishment of the Society in the 18th century,' commented Penrose sceptically, 'although this was part of a mythology that was built up over the period covered by this inquiry.'[37]

In practice, doubtless inadvertently, 'full distribution' was taken too far, resulting in over-allocation of bonuses and over-payment on claims. The outcome of the 'cumulative effect of over-allocation, in particular the resulting over-payment on maturities and other claims from 1987 onwards' was, Penrose estimated, that by 31 December 2000 policy values (liabilities) exceeded assets by around £3 billion.[38] Plainly there was a serious underlying solvency issue, but no immediate crisis since life insurance companies generally do not have liquidity issues or suffer runs on deposits that bring down banks.

Due to 'full distribution' Equitable had relatively little in the way of free assets (estate) to meet a major unexpected demand on its resources: for 1999, reported *The Economist*, Equitable's free asset ratio was 8 per cent, compared to an industry average of 18 per cent, with ratios at leading rivals of 20 per cent at Standard Life, 22 per cent at Prudential and 23 per cent at Scottish Widows.[39] The absence of a substantial estate was well known to regulators and other life companies.

The FSA told Baird's inquiry that:

It is sort of self-evident that the less surplus you have got, the more exposed you are to accidents, surprises, or...shocks... I think the question was, was it a reasonable approach for the company to take, or was it so unreasonable that the Regulator should have done something about it? I think our judgement was that it was clearly a factor and, if you like, a risk, but the company were aware of it; the company took a judgement on how much to pay out each year, and that was...a big bonus for the policyholders... Against that has to be set the risk that unexpected shocks would leave them with less fat. But that is a judgement that every company has to make. The Equitable were perhaps at one extreme, or near one extreme, in terms of the way that judgement was exercised.[40]

Likewise the Government Actuary's Department:

There's not a lot you can do about it if the company chooses to operate its business in that way; we would keep a close eye on it, and we have expressed the view to the company, over at least ten years, that we weren't exactly comfortable with the way that they operated, but the company, I suppose, were arrogant in that respect, and felt that they knew best.

Equitable's business model of the 1980s and 1990s delivered growth – assets ballooned six-fold from £5 billion to £30 billion – and gratified policyholders. It did so apparently through professionalism, low costs and best practice. But in reality, observed Charles Thomson, Equitable's post-crisis chief executive in the 2000s, the model was 'incompetent, very aggressive in terms of sales, and they had relatively little capital which they were burning through at a high rate'. A further problem was that, as a mutual, Equitable was unable to raise funds in the market by issuing shares. 'The corollary of the absence of shareholders as competitors for the Society's assets and profits,' Penrose observed, 'was the absence of a source of external funding in case of need.'[41] And then there was the potential 'time-bomb' of the guaranteed annuity rate policies. 'They made only one mistake,' the chief executive of a rival told the *Financial Times*. 'It wasn't such a great mistake either, but the unique way they ran the business meant they could never afford to make any mistake.'[42]

Equitable Life crisis

The 'mistake' emerged in October 1993 – falling inflation and interest rates led market annuity rates to dip below Equitable's guaranteed rate for the first time.[43] Most likely there would be an increased take up of the option, a liability for which no provision had been made.

By September 1998, Equitable's guaranteed annuities were worth 30 per cent more than annuity rates in the market, posing a significant financial threat

It was a point at which there was an opportunity to begin to reserve for a growing GAR liability, but that would have disappointed policyholders and lowered Equitable's ranking in the league tables. Instead the Equitable board, apparently guided by Ranson and the Equitable's in-house actuaries, responded by adopting a 'differential terminal bonus' whereby policyholders who opted to take up their guaranteed annuity option received a lower terminal bonus, in practice nullifying the guarantee. 'Equitable Life's risky decision in 1993 not to build up a reserve to cover the cost of Guaranteed Annuity Rate (GAR) liabilities was a crucial turning point,' commented the Treasury Select Committee's report.[44] But then in spring 1994 inflation and interest rates took off again and the GAR issue went away – for the time being.

The authorities' determination to get inflation under control reversed the rise and from May 1995 Equitable's GARs were again higher than those generally available in the market. The granting of operational independence to the Bank of England by the new Labour administration in May 1997 reinforced the downward pressure on inflation. By September 1998, Equitable's guaranteed annuities were worth 30 per cent more than annuity rates in the market, posing a significant financial threat. 'At the very least, the actuaries are open to the accusation of being mathematically sophisticated but economically illiterate,' stated financial commentator John Plender. 'They appear to have paid more attention to rates of inflation during the 1970s than to the very low rates that have prevailed for most of the period since 1762 when Equitable was founded. None of those involved appears to have questioned this judgment closely.'[45] History was also invoked by Ned Cazalet, an insurance consultant and adviser to the Treasury Select Committee, who observed that: 'To the South Sea Bubble, Dutch tulip mania and the recent dotty dotcom boom-and-bust, must surely be added the widespread granting by life offices of guaranteed annuity options on pensions contracts written in the high-inflation 1970s and 1980s.'[46] Cazalet estimated that guaranteed annuities cost the life assurance sector as a whole a total of £10 billion, but while all the other affected providers had sufficient free assets to 'bite the bullet', Equitable's 'full distribution' practice meant it was unable to do likewise.[47]

The onset of the Equitable crisis happened to coincide with the institutional reshuffle of financial services regulation that combined teams from ten agencies into a single regulator, the Financial Services Authority (FSA). For more than a century the prudential supervision of the life assurance industry had been the responsibility of the Department of Trade and Industry (or forerunners), advised by the Government Actuary's Department. In January 1998, this responsibility was transferred to the Treasury. Then on 1 January 1999 it was assumed by the newly created FSA. 'Question: What were the financial regulators doing while all this was going on?' quipped an article entitled 'Who is to Blame...for the Equitable Life debacle?' in the *Financial Times*. 'Answer: Moving offices, mainly.'[48]

Equitable's issue with its potential GAR liabilities and its differential terminal bonus solution burst into public view in the press in August 1998.[49] In January 1999 the newly minted FSA issued a guidance letter on insurance company solvency margins stipulating that it should be assumed that at least 80 per cent of qualifying policyholders would choose to exercise their guaranteed annuity option. Hitherto firms had been free to decide the likely level of take up, with Equitable anticipating that only 2 per cent of policyholders would do so. Management estimated the cost at an affordable £50-200 million, but under the FSA's new rule it would have to find £1.5 billion, a distinctly different matter. Consideration was given to using derivatives to hedge the exposure, but the products were deemed inadequate or too costly. Instead, accounting techniques were used to boost Equitable's solvency position; the profit estimate was raised from £370 million in 1997 to £850 million for 1998, and it bought a reinsurance policy that put an extra £800 million of capital on the balance sheet.[50] 'Reinsurance is a powerful portfolio management tool,' noted Baird, 'that enables insurance companies to accept large or unusual risks and reduce the effect of variations in claims experience from year to year.'[51] But it was a stop-gap, not a solution.

Following an increasing number of policyholder complaints, the Equitable board decided to test the lawfulness of its differential terminal bonus allocations. It took a test case to the High Court, which in September 1999 backed the management's right to cut bonuses as 'well within their

The law lords found Equitable in breach of contract – a guarantee was a guarantee

On 8 December 2000, the last potential purchaser having walked away, Equitable closed to new policyholders and began to seek buyers for bits of the business

Charles Thomson

They thought they would sell the business for £4 billion, but they discovered they couldn't sell it at all

Maurice Ogborn, aged 93, instigator four decades earlier of the GARs, offered to return his pension

discretion'. 'There was huge relief. There wasn't a wild party. Equitable isn't that kind of a company,' recalled an adviser, 'but the chief executive did open a bottle of champagne.' [52] Management, apparently, was also reassured by a letter from the Treasury suggesting that its approach to the annuity guarantee issue was legitimate.[53] But in the Court of Appeal, while one of the three judges found in favour of Equitable, two found against. 'They thought it was a formality,' said an adviser at the time. 'No one gave any consideration that they'd lose. So, when the decision came, there was disbelief.' [54] The split judgment led to the House of Lords for a final definitive judgment. The law lords found Equitable in breach of contract – a guarantee was a guarantee. The judgment invalidated the reinsurance contract, pushing Equitable's minimum solvency margin to a hazardous level.[55] 'The decision,' stated Penrose, 'and the additional liability of £1.5 billion on top of that erosion of fund value through over-allocation and over-payment made future independence impossible.'[56] As of lunchtime on Thursday 20 July 2000, Equitable was 'relegated to the transfer list.' [57]

Many in the life business saw Equitable's troubles as *sui generis* and self-inflicted. 'Equitable was daft and gave these guarantees. We don't do that so it's not relevant for us,' Sir David Walker explained. 'And there was probably a sense of "they got their comeuppance."' 'Equitable always reckoned it was a cut above the rest of the industry. Founded in 1762 and all that,' noted the *FT*. [58] 'I remember being at one City event about the importance of brand,' recalled Alex Brummer. 'And the Equitable people just didn't engage at all. They said: "Our name speaks for itself".'

With its 'strong brand', 'excellent efficiency', renowned sales force and highly desirable roll of policyholders, it was anticipated that Equitable would be snapped up.[59] Indeed, fifteen potential purchasers expressed an interest – but one by one they pulled out having looked at the books. The GAR liability was one factor, but there was also the over-distribution and the depreciation of the value of assets due to falling share prices. Equitable's investments were significantly in equities, but the stock market, which had peaked in December 1999, was plunging with the bursting of the dot.com bubble.

On 8 December 2000, the last potential purchaser having walked away, Equitable closed to new policyholders and began to seek buyers for bits of the business. 'They thought they would sell the business for £4 billion,' said Charles Thomson, 'but they discovered they couldn't sell it at all.' 'It is difficult to avoid the conclusion that the mutual has been guilty of hubris,' commented the *Financial Times*. 'In July, Equitable put up the "for sale" sign. By December, it had the "fire sale" sign out.' [60] Aghast at the wreckage, Equitable's president, John Sclater, offered 'a most sincere apology' to policyholders and likened developments to 'a Greek tragedy that has unfolded with ghastly speed'. [61] Maurice Ogborn, aged 93, instigator four decades earlier of the GARs, offered to return his pension.

The new year saw a new president, City lawyer Vanni Treves, a new senior management team, led by chief executive Charles Thomson, and a new board of directors who undertook an orderly, but for some controversial, 'run off' of Equitable's liabilities and assets. Equitable's continuation was shepherded through painful adjustments of liabilities to policyholders in line with what funds were actually worth, beginning in July 2001 with a 16 per cent cut. Then there was the sale of realisable parts of the business, the negotiation of a compromise settlement between the various categories of policyholders to stabilise the business, and an unsuccessful pursuit of compensation from the firm's auditors and former directors. By summer 2008, the rump of the business was in sufficient order that several potential purchasers were interested in acquiring Equitable's remaining 500,000 policyholders. But for a second time the timing was disastrous. In October came the collapse of Lehman Brothers and the crisis in the financial markets, which put paid to that plan.

Culpability and compensation

The Equitable collapse was the biggest crisis in the modern history of British insurance or pensions, both as regards the number of innocent parties involved and the loss of funds. Its tribulations were followed closely by the press, especially Alex Brummer at the *Daily Mail*, Ian Cowie at the *Daily Telegraph*, and by the *Financial Times*. They were publicly aired before the Treasury Select Committee. There were five official inquiries, notably

Lord Penrose, *Report of the Equitable Life Inquiry* (March 2004) (817 pages), and the Parliamentary Ombudsman, *Equitable Life: A Decade of Regulatory Failure* (July 2008) (2,819 pages). Other reports – the Equitable Members Action Group (EMAG) website lists 30 'Vital Reports' – include: Treasury Select Committee, *Equitable Life and the Life Assurance Industry: an Interim Report* (March 2001); Corley Report into Equitable's implications for the actuarial profession (September 2001); Ronald Baird, *Report of the FSA on the Review of the Regulation of Equitable Life Assurance Society from 1 January 1999 to 8 December 2000* (October 2001) (234 pages); Parliamentary Ombudsman, *Report on Prudential Regulation of Equitable Life* (June 2003); European Parliament, *Report of the Committee of Inquiry into the Crisis of the Equitable Life Assurance Society* (May 2007) (385 pages); and Sir John Chadwick, *Equitable Life Ex-gratia Payments Scheme Final Report* (July 2010).

Lord Penrose, an accountant and commercial judge, was appointed by the government in August 2001 to investigate the circumstances leading to Equitable's downfall and reported thirty months later. 'Lord Penrose's examination of the failure of Equitable Life runs to three times the length of an Agatha Christie novel and appears at times to borrow from some of her wilder plots – the ones where the entire cast conspires to pull off the murder,' commented Lex.[62] 'The Equitable disaster created enough blame to go round and Lord Penrose has distributed it liberally – to the regulatory system, the accounting standards setters, the mutual's corporate governance structure, its deficient non-executives and its autocratic managers.' Penrose laid the most blame on the Society's senior executives and directors, his general verdict being that 'the Society was the author of its own misfortunes'. He was personally critical of Roy Ranson, Equitable's 'idiosyncratic and autocratic' actuary and chief executive, a 'domineering figure who brooked no dissent'.[63] Penrose was disparaging as regards Equitable's non-executive directors, who he found 'did not understand the risks to which the Society was exposed' and had 'a poor understanding of the Society's developing financial position,' being 'ill-equipped to manage a life office by training or experience' and 'incompetent to assess the advice objectively and challenge the actuaries'.[64] 'But,' he observed, 'it may be appropriate to comment that the practices of the Society's management could not have been sustained over a material part of the 1990s had there been in place an appropriate regulatory structure.'

'There are no simple answers to questions of who lost and who is to blame,' Penrose wrote in a letter to Treasury minister Ruth Kelly which accompanied his report, 'but it is clear that the situation that was allowed to develop at Equitable has led to hardship and distress to many innocent people.' Penrose's 'painfully detailed' analysis and broad spectrum of blame disappointed policyholders, and others, looking for clear-cut attributions of culpability that would bolster claims for compensation. A *Financial Times* editorial likened the report to 'fog', while Alex Brummer called it a 'damp squib' and observed that 'the volume of evidence and the technical detail at the heart of the inquiry seemed to have got the better of him'.[65]

In the wake of the Penrose report, in July 2004, the Parliamentary Ombudsman, Ann Abraham, announced that she was reopening her investigation into the government's role in the prudential regulation of Equitable Life. Her first report in July 2003 – during the Penrose inquiry – cleared the FSA of wrongdoing. Her second report, which, repeatedly postponed, eventually appeared in July 2008, focused on the charge of regulatory maladministration. Entitled *Equitable Life: a decade of regulatory failure*, her damning report chronicled 'serial regulatory failure' and called on the government to apologise to policyholders and compensate them for losses. Government compensation for Equitable policyholders was also 'strongly recommended' by a European Parliament report of May 2007.[66] But Labour politicians resisted and procrastinated, fearful of the bill, with policyholder losses being estimated at £4-5 billion.

Yet another official report was commissioned to be undertaken by Sir John Chadwick, a retired judge, to determine how much compensation should be paid and how it should be allocated. Controversially, his report in July 2010 recommended a total payment of between £400 and £500 million. Ombudsman Abraham was outraged, publicly denouncing Chadwick's proposals as 'unsafe and unsound' and advocating a higher level of government compensation.[67] The Equitable Members Action Group

The Equitable Members Action Group continued its tireless fight for compensation on behalf of policyholders

(EMAG) continued its tireless fight for compensation on behalf of policyholders. In the run up to the 2010 general election, EMAG secured the pledges of many hundreds of MPs, and prospective MPs, to adopt the recommendation of the Parliamentary Ombudsman. Through EMAG's influence, both the Conservatives and Liberal Democrats included a commitment to compensation in their election manifestos. In October 2010 the new coalition government announced that Equitable policyholders would receive £1.5 billion – three times Chadwick's figure but well short of the £4.3 billion the government accepted policyholders had lost. Campaigners called the figure 'woefully inadequate', but in the context of tax rises and spending cuts further public funds were unlikely. Thus the announcement appeared to open 'the final chapter in this sorry saga'. [68]

Equitable crisis factors

The Equitable crisis features a variety of factors that contributed significantly to its collapse:

- Leadership: an autocratic, domineering chief executive.[69]
- Business model: a risky business model ('full distribution' and the resultant low reserves) that delivered rapid growth – for a while.[70]
- Governance: non-executive directors who failed to control an ambitious management or to understand the risks they were running.[71]
- Regulation: a failure of prudential supervision to restrain the hazardous conduct of the firm and protect stakeholders.[72]
- Product: complex and opaque products (traditional with-profits life policies).[73]
- Crisis management: over-confidence in ability to overcome problems (the GARs) (unexpected House of Lords judgement) (unexpected inability to sell the firm).[74]
- Institutional constraints: inability of mutual to raise capital.[75]

The Equitable crisis was not the first or last time that a financial institution would be challenged by some combination of these factors (and perhaps others), as Northern Rock, RBS, HBOS and Bradford & Bingley would soon demonstrate.

Insurance Industry

Shockwaves

Equitable's escalating crisis in the second half of 2000 sent shockwaves through the insurance industry, regulators, politicians and policyholders. After the House of Lords' judgment, closure to new business in December triggered the commissioning of an FSA inquiry into Equitable's recent regulation (Baird). The appearance of Equitable and FSA representatives before the House of Commons Treasury Select Committee in February 2001 was followed the next month by a report that posed a variety of searching questions about the management and regulation of Equitable with implications for the insurance industry more broadly.[76]

Equitable's announcement in July 2001 of a cut in bonuses generated an 'absolute outcry,' said John Tiner, at the time the recently appointed FSA managing director for consumer, investment and insurance issues. 'It was very big news and very damaging.' And it came hard on the heels of another insurance industry bombshell – the collapse of Independent Insurance, a large general insurance company. Independent Insurance – 'a drama laden with hubris' – achieved spectacular growth and reported profits in the 1990s, with the share price rising eight-fold between 1993 and 2000.[77] But its stellar results were achieved through under-pricing premiums and under-reserving losses. To hide its fundamental problems, Independent began to use reinsurance contracts but without disclosing the payback obligations. When in June 2001 it tried to raise additional capital the secret 'side letters' were revealed, with the result that the share issue collapsed and Independent was found to be insolvent; three senior executives went to jail.

Independent Insurance was one of 18 case studies analysed in Cass Business School's report *Roads To Ruin; A Study of Major Risk Events: their origins, impact and implications* (2012). Some of the lessons of the Independent failure drawn by Cass were familiar from Equitable, notably:

1. 'The dangers of a charismatic/ autocratic/demonic leader' – in sentencing Michael Bright, chief executive, Judge Rivlin described him as an over bearing bully who 'introduced a fear factor into the working lives of your managers;'[78]
2. 'Failure of non-executives to restrain executives;'
3. 'Ignoring early warning signs.'

   'A dominant chief executive, heady expansion by an upstart company in a cut-throat market, self-delusion about the strength of the company, questionable accounting. These were all apparent in the collapse of Vehicle & General Insurance just over 30 years ago,' observed John Plender, characteristically providing a long-view perspective. 'They have been apparent all over again in the demise of Independent Insurance.'[79]

Following the Equitable announcement the FSA board mandated Tiner to lead a 'complete overhaul' of insurance regulation, which became known as the 'Tiner Project'.[80] 'What it did was look at insurance regulation and realise that the whole system, up to that point operated on the prudential side by the DTI which had recently come into the FSA, and the Personal Investment Authority on the sales side, was somewhat antiquated frankly,' said Tiner. 'It was based on detailed after-the-event actuarial analysis and not looking at the business. Not looking at the risk of the business. Not looking at real world liabilities as opposed to contractual liabilities, and things like that. So we introduced realistic reporting of liabilities and I have always found it really odd that this seemed revolutionary... It was pretty clear to me that one of the major failings of the whole system, enabling Equitable to get to the position it did, was that it didn't reserve for terminal bonuses because they were not contractually due. And that is true, but they were consistent with

Sir David Walker

I see the relationship between prudential supervision and good governance, in particular the risk appraisal and control process, as being like two blades of a pair of scissors, and if only one blade is sharp you won't get a good cut

Hector Sants

We thought long and hard and have used the Equitable Life case study to inform the new regime

policyholder expectations and therefore should have been reserved.' There was also 'significant enhancement' of insurance companies' capital requirements which were, as an insurance executive put it, 'hurried in following Equitable'.

'The Equitable experience gave prudential supervision of the insurance business a shove in the direction of making it much more serious and professional,' observed Sir David Walker. 'I see the relationship between prudential supervision and good governance, in particular the risk appraisal and control process, as being like two blades of a pair of scissors, and if only one blade is sharp you won't get a good cut. To get a good cut you need both blades to be sharp.'

Subsequently, in the wake of the 2007-08 financial crisis, the FSA is currently being succeeded by a new 'twin peaks' regulatory regime, with separate authorities focusing respectively on prudential and conduct regulation. 'In designing the twin peaks regime we looked very carefully at the Equitable Life experience,' said former FSA chief executive Hector Sants. 'We thought long and hard and have used the Equitable Life case study to inform the new regime, and I hope that we have made sure that the lessons learned from Equitable Life have not been lost as a result of the structural changes. We are very conscious that we don't want to create new risks in the insurance sector as a result of changes to the regulatory landscape which have been primarily driven by events in the banking sector.'

Learning from Equitable

The Tiner Project coincided with the beginnings of a review of insurance regulation by the European Commission – the *Solvency II* project. A working group of insurance supervisors from 15 EEA (European Economic Area) countries was set up to review the experiences of failed and 'near miss' European insurance companies from 1996 to 2001, to draw 'practical lessons from the past and to highlight emerging trends in the risks faced by insurance companies'. [81] The working group met eight times between June 2001 and September 2002, its work and findings being published as: *Prudential Supervision of Insurance Undertakings: Report of the London Working Group on Solvency II* (December 2002). FSA executives took a leading part in the working group, resulting in the FSA paper: *Managing Risk: Practical lessons from recent 'failures' of EU insurers* (December 2002). Thus there was significant interaction between the EEA exercise and the Tiner Project, the former providing 'considerable empirical support to much of the regulatory reform that is already underway in the UK and elsewhere'.[82]

Out of a total of no fewer than 270 eligible episodes of failure or near-failure, the working group selected 21 cases for detailed scrutiny as covering the main risks. It designed a 'risk-map' that was 'compiled from risks that had recently caused difficulties and was structured by supervisors with extensive experience of how these risks arise'.[83] This was used as the basis for analysis of the case studies and 'proved a good fit and significantly enhanced the group's analysis'.[84] Based on the analysis of the detailed case histories, the working group drew four principal regulatory conclusions:

- management problems appear to be the root cause of every failure or near failure, so more focus on underlying internal causes is needed;
- firms, supervisors and others need to anticipate how risks can interact in complex ways, including causal links between different types of risk (for instance operational risks and underwriting risk or claims evaluation risk) and unexpected correlations (particularly between certain asset and underwriting risks); the group's risk-map is likely to be helpful for this;
- moving to a risk-based approach brings benefits and at the same time has implications for policy-making and supervision – the subjective nature of the supervisory assessments means that different approaches may be needed, including more forward-looking tools as well as greater international cooperation; and
- it is important to strike the right balance between prescriptive rules, principles, incentives and diagnostic tools.

Although the cases were amalgamated and anonymous, Case Study 6: *Life insurer – high expectations/long-term interest rate guarantee* – suggested similarities with Equitable. [85] The Case Study 6 synopsis noted that:

In these cases, management of life insurers set policies that gambled on future economic conditions. The interest rate guarantees contained long-dated options that

...while the insurance supervisors looked to learn from their banking counterparts, the reverse does not appear to have been the case

could be expensive to service if rates fell significantly...

Although the dramatic shift in interest rates was felt across the market, in some cases the problems were compounded by a reluctance by management to admit the problem, understandable as this would have serious repercussions on the new business rate...

An excuse is that it had been the market norm to treat long-term guarantees at well below historical levels as not being onerous; but it was felt that in the worst cases management were late to understand or acknowledge the nature and extent of the risks in the business.

Lessons: In such situations an external actuary might give a better opinion. The risks might have been identified through stress testing the portfolio under a variety of assumptions about future economic and market conditions, or in the case of the guarantees by applying sophisticated valuation methods to the embedded derivatives, e.g. capital market techniques. Where expectations have been created, the financial cost of meeting these should also be estimated and provided for, to ensure that the firm can treat its customers fairly.

Plainly, both the FSA and EEA insurance supervisors actively analysed and learned from Equitable, drawing lessons that fed into their contributions to the Tiner Project, 'twin peaks' and the *Solvency II* exercise.

Insurance industry supervisors looked at banking supervisory practice for useful ideas. One such borrowing was the proposed appointment of 'Grey Panthers' – retired insurance executives and actuaries – to advise insurance supervisors.[86] 'I wanted the Grey Panthers to kind of prowl around the place,' explained Tiner enigmatically, it being hoped that their insider insights would help to 'root out wrongdoing', perhaps to compensate for ineffective non-executive directors.[87] A working group of EEA banking supervisors, who had recently studied European 'banking difficulties' in the decade 1988-98, found that 'management and control weaknesses were underlying, fundamental and contributory in almost all of the cases'.[88] The EEA insurance supervisors' working group pointed out that its conclusions drawn from its 21 case studies were similar, adding that their own conclusions were 'not unique to the insurance industry'. But while the insurance supervisors looked to learn from their banking counterparts, the reverse does not appear to have been the case.

The insurance industry and the 2007-08 financial crisis

'I have no doubt,' said a regulator, 'that if we hadn't seen the Tiner reforms, the life insurance sector in the UK would have been much more adversely affected by the financial crisis than it was, particularly once we got into the period of low equity markets, and so forth, which came in 2008 post the Lehman collapse.' 'There was read across from Equitable in the life sector of the regulators, and a good understanding that those businesses needed to be better capitalised,' said a senior insurance executive. 'There, I think, you can see a direct link and it explains why UK life insurers came away from the financial crisis incredibly well.'

'In general, the traditional life and general insurance sectors have largely been bystanders in the crisis,' observed an OECD report: *The Impact of the Financial Crisis on the Insurance Sector and Policy Responses* (February 2011).[89] Fortunately, most insurers, especially European ones, had limited direct exposure to either the epicentre of the 2007-08 financial crisis, the US mortgage market, or related securities.[90] In fact, stated the report, 'the insurance sector arguably provided a stabilizing influence in light of its longer-term investment horizon and conservative investment approach'. But, cautioned Jon Pain, a former senior regulator, 'if globally governments, central banks, taxpayers hadn't stepped in to support the banking system, they would have got burnt heavily because of their exposure to banks.' With the intensification of the crisis in September 2008, insurance companies were battered by 'knock-on effects' – stock market falls, low interest rates, weakened credit quality and the economic slowdown – but generally they coped.

The egregious exception was American International Group (AIG), which in September 2008 had to be rescued by the US government for fear of an even greater systemic disaster than Lehman Brothers, which failed simultaneously. New York headquartered AIG was the world's largest insurance group, operating in 130 countries with 70 million customers, and the world's 18th largest corporation. It was America's largest life insurer, but it had also developed a huge wholesale financial markets

...nobody at AIG learned anything from the Equitable Life

business. AIG played a key role in the build up to the financial crisis by providing financial insurance for complex structured products, thereby enhancing their attraction to investors and their global distribution, which was the activity that got it into trouble.

The AIG collapse was another *Roads to Ruin* case study.[91] Several of the lessons from AIG were familiar from Equitable:

1. 'A lack of understanding of the business by top managers and the board' – if something is too good to be true, it is probably too good to last – you only consistently earn high returns for consistently taking high risks;
2. 'Beware of the cult of the personality' – chief executive Joseph Cassano lacked a strong mathematical background (essential to understanding what AIG Financial Products' (AIGFP) rocket scientists and traders were up to) and was reported by colleagues as a workplace bully who imposed an autocratic management style. One of them said: 'Cassano had a crude feel for financial risk but a real talent for bullying people who doubted him. AIGFP became a dictatorship.'
3. 'Failure of non-executive directors' – as well as dominating internal management, AIG chief executives dominated the board. Many of the 15 non-executive directors, average age 66, were distinguished former politicians and officials for whom understanding of Credit Default Swaps was hardly a strong point; and
4. 'Failure of regulation' – unregulated complex products were heavily traded by a company regulated by the Office of Thrift Supervision, which was hopelessly out of its depth. Given that much of AIGFP's operations were conducted in London, there is a possibility that some executives might have been familiar with the Equitable story. But plainly nobody at AIG learned anything from the Equitable Life.

The 2007-08 Financial Crisis

The financial crisis of 2007-08 was first and foremost a banking crisis. From mid-October 2008, five out of the eight major British banks were wholly or partially in public ownership – Northern Rock; Bradford & Bingley; HBOS; Lloyds; and RBS – receiving injections of public funds to recapitalise them. Why did so many British banks require government support? Why were so many British banks in crisis? Were there similarities between these crises and Equitable?

The roots of the banking crisis were many and varied, notably: global capital imbalances that led to low real interest rates; a consequent 'search for yield' – demand for assets offering higher returns – encouraging greater risk-taking; moderate retail price inflation but significant asset price inflation; increased leverage (lower capital/debt ratios); financial innovation, including the spread of the 'originate and distribute' banking model using loan securitisation in contrast to traditional 'originate and hold' lending; and the development of complex opaque 'structured product' investments, notionally delivering enhanced yield. These ingredients, noted the House of Commons Treasury Select Committee, 'combined to create an environment rich in over-confidence, over-optimism and the stifling of contrary opinions.' Banks responded to the challenges and opportunities in individual ways, but an increased assumption of risk was a common factor.

Northern Rock, September 2007

Newcastle-based building society Northern Rock converted to a bank in 1997. This allowed it freedom to develop its mortgage lending business in new ways and to diversify funding. It also created pressure to make profits for shareholders, who included 75 per cent of staff and executives with share options. Management, led from 2001 by Adam Applegarth, set its sights on growth, and with house prices rising strongly business prospects looked good. Growth meant on the one hand winning new mortgage business, and on the other raising funds to lend. Traditionally building society lending had been funded from savings accounts, but as a bank Northern Rock had access to the wholesale money markets of which management proceeded to make full use. Northern Rock's 'extreme' business model featured just 30 per cent of funding coming from savings accounts and 70 per cent from wholesale funding – 20 per cent from the short-term inter-bank wholesale money markets and 50 per cent from securitisation. This was a far higher level of reliance on wholesale funding than any other British or European bank.[92] Securitisation, a new technique in the British housing market, involved the assembly of a bundle of mortgages, each of which generated an income stream, which was sold to an investment bank earning a commission. The latter would then engineer the bundle into a structured product (bond) that would be sold to investors. Periodic securitisation sales provided Northern Rock with funds with which to make new mortgage loans. In between securitisations, it would borrow in the wholesale money markets.

The business model was also extreme on the lending side. To win business, borrowers were offered high loan to income/value ratios. Moreover, its 'Together' product, which comprised a quarter of lending by 2007, offered loans of 125 per cent, based on 95 per cent of the property value plus a 30 per cent unsecured loan. But with house prices advancing, the loan would soon be covered by the mortgage. Northern Rock insisted that its mortgage book was high calibre, but there are indications that the dash for growth had compromised lending quality – from 2005 staff under-reported mortgage arrears, for which three executives were later fined and banned from banking by the FSA.

Northern Rock's business model delivered spectacularly – for a while. Over the decade to 2007, assets increased six-fold, from £16 billion to £101 billion, making it the UK's fifth-largest mortgage lender. It accounted for 20 per cent of new mortgage business in 2006. With costs tightly controlled, profits soared from £250 million in 2000 to £590 million in 2006 driving the share price from £4.70 to £12.50, giving the bank a market capitalization of £6 billion.

In 2007 the UK house price boom peaked and there were signs of distress in the US subprime mortgage market. Securitisation had been extensively used for subprime mortgages and the rapidly rising delinquency rate compromised the value of structured products created from the loans, causing banks to worry about lending to other banks, suspicious about their exposure to such toxic assets. On 9 August 2007 the inter-bank lending market ceased to function, closing down Northern Rock's access to short-term borrowing. It had a securitisation scheduled for 17 September, but the market for bundles of mortgages had also shut down. Unable to raise funds to meet maturing borrowings, on Wednesday 12 September it applied to the Bank of England for a support facility. On 13 September, while the facility was being put together, Robert Peston, BBC Business Editor, reported that Northern Rock was being bailed out. Next day, despite an official announcement of the facility, queues formed outside Northern Rock branches and £2 billion of deposits was withdrawn. On Monday 17 September the Chancellor announced a government guarantee of all deposits at Northern Rock, which stopped the run.

By January 2008, Northern Rock's borrowings from the Bank of England had grown to £26 billion. Attempts were made to find a buyer but worries about asset quality compounded the problems on the funding side, and Chancellor of the Exchequer Alistair Darling rejected the bids received as not providing 'sufficient value for money for the taxpayer'. On 22 February 2008, Northern Rock was nationalized. Northern Rock's chairman, Matt Ridley, four non-executive directors and Applegarth resigned, though the latter continued in a caretaker role and received a £760,000 pay off (a controversial 'reward for failure'). The collapse resulted in around 2,000 redundancies, many of them in the North East, with the blow to the region's economy an estimated £800 million. When Northern Rock's shares were suspended on 18 February its 100,000 small shareholders lost their nest eggs.

The Northern Rock disaster highlighted a variety of weaknesses, some of which shared common features with those identified in Equitable's case:

1. The business model:
   Described by the Treasury Select Committee in its report *The Run on the Rock* (January 2008) as a 'high risk, reckless business strategy, with its reliance on short- and medium-term wholesale funding and an absence of sufficient insurance;' [93]
2. Governance:
   'The directors of Northern Rock were the principal authors of the difficulties that the company has faced since 2007... The non-executive members of the Board, and in particular the Chairman of the Board, the Chairman of the Risk Committee and the senior non-executive director, failed in the case of Northern Rock to ensure that it remained liquid as well as solvent, to provide against the risks that it was taking and to act as an effective restraining force on the strategy of the executive members;'
3. Leadership and management:
   Neither the chief executive nor the chairman was a qualified banker and did not appreciate the risks. Furthermore, there was a lack of proper financial controls and the absence of a functioning risk management system.[94] A former colleague called Applegarth 'arrogant' and advised against ever investing in 'a company whose chief executive is all powerful and believes he is right all the time.' 'As is so often the case,' observed a study of the financial crisis, 'top management hubris is a forerunner of nemesis in the form of the corporate grim reaper;' [95]
4. Regulation:
   'We regard this as a substantial failure of regulation,' declared the Treasury Select Committee. 'The FSA did not supervise Northern Rock properly. It did not allocate sufficient resources or time to monitoring a bank whose business model was so clearly an outlier; its procedures were inadequate to supervise a bank whose business grew so rapidly.' [96] The *Roads to Ruin* report, which featured Northern Rock as a case study, observed that, 'none of the Tripartite Authorities (namely the FSA, Bank of

England and Treasury), which shared regulatory responsibility, nor the credit rating agencies, nor the auditors appear to have raised any concerns about Northern Rock's business model and its inherent risky reliance on wholesale funding markets. In March 2011, the House of Lords Select Committee on Economic Affairs said that the failure of audit firms to blow the whistle on reckless banks in the run-up to the financial crisis was down to a culture of box-ticking and neutrality at the expense of prudence.'

5. Crisis containment:
   Poor crisis management aggravated both episodes and in neither case could a buyer be found for the business; and
6. Casualties:
   Both cases featured losses by numerous innocent parties.

HBOS/Lloyds, September 2008

HBOS, formed in 2001 by the merger of Halifax, a former building society and Britain's biggest mortgage lender, and Bank of Scotland, grew rapidly in the five years preceding its demise in 2008. At its peak in 2007 it had 10 million customers, 74,000 staff, a market capitalization of £35 billion and made £5.7 billion of profits. It was, recalled Brummer, 'a very aggressive marketer of products. In fact so aggressive that it could put its whole business in the hands of someone with no banking experience at all – Andy Hornby,' the chief executive who was previously retail managing director at supermarket Asda. His predecessor James Crosby was an actuary by profession. HBOS focused particularly on property lending, both residential, with 20 per cent of the mortgage market, but especially commercial property lending. Under the direction of Peter Cummings, HBOS massively expanded its real-estate lending as well as effectively taking risky equity stakes in property development vehicles. The expansion of lending was funded largely by borrowing in the wholesale money market. Invited to characterize the cause of HBOS's downfall, Hornby told the Treasury Select Committee that 'it was the combination of being property-based on one side of the balance sheet with a significant reliance on wholesale funding on the other'.[97]

HBOS was hit hard by the conjunction of crashing property prices and the breakdown of the wholesale money market in 2007 – commercial property losses were £6.8 billion (though the retail arm made a £1.3 billion profit). And there was another grave problem. The bank's 'search for yield' had led it to 'invest' £21 billion in high-yield structured products that were held in undisclosed off-balance sheet vehicles, half of which related to troubled US mortgages. When this was revealed in March 2008 investors were alarmed and the share price slumped, while other banks became reluctant to deal with the stricken lender. Following the collapse of Lehman Brothers, HBOS's share price crashed from 283 pence to 88 pence (it was 450 pence six months earlier) the market signalling that HBOS was next. No longer viable as an independent bank, on 18 September Lloyds TSB, a prudent bank thus far unscathed by the crisis, announced that it had reached an agreement to acquire HBOS.[98] It did so with government facilitation through a waiver of competition rules. But instead of keeping HBOS afloat, the losses from HBOS's commercial property business undermined the Lloyds business model. The banking crisis intensified, resulting in October in the injection of £37 billion of new capital into the banking system by the government. The recipients were HBOS, RBS and Lloyds, the government shareholding in the combined Lloyds Banking Group becoming 43.5 per cent.

HBOS's crisis was the outcome of an extreme (commercial property lending) business model led by Peter Cummings, a 'seemingly unaccountable' chief executive of the commercial lending business. [99] A further similarity with Equitable appears to be the lack of risk awareness and 'economic illiteracy' of the board and management: 'In truth,' HBOS chairman Lord Stevenson told the Treasury Select Committee, 'we failed to consider some of the extreme scenarios that have actually happened.' [100]

Bradford & Bingley, September 2008

Following conversion from building society to bank in 2000, Bradford & Bingley grew rapidly – its loan book more than doubled by 2008 – based on a brassy new business plan.[101] On the lending side it focused on self-certified and buy-to-let mortgages, building a 20 per cent market share – mortgage products distinctly on the riskier fringe. Some of the loans derived from mortgage originator GMAC, with which the bank entered a long-term agreement for a regular supply of loans. A sharp deterioration in the market, as happened from 2007, had been 'difficult to envisage' when the contract was signed, the chairman explained to the Treasury Select Committee, but the bank continued to be obliged to take the loans despite having increasing difficulty securing the funding to do so.[102]

Much of the funding for Bradford & Bingley's growth came from borrowing in the wholesale market: in 2000, 16 per cent; in 2008, 41 per cent. Ratings agency downgrades of the bank's credit status in summer 2008 as business conditions deteriorated, followed by the Lehman Brothers failure, triggered runs on both wholesale and retail deposits, leading to the collapsing business being taken into public ownership. The similarities with Equitable are in the pursuit of growth through what proved to be an unsound business model, and the inflexible contract with GMAC which has echoes of Equitable's guaranteed annuity commitments.

RBS, October 2008

On 7 October 2008, RBS, recently the world's fifth largest bank, was forced to turn to the Bank of England for Emergency Liquidity Assistance, being unable to raise funds in the wholesale money markets. On 13 October, to restore capital to an adequate level, the bank undertook a £20 billion capital raising underwritten by the British government. Since private investors subscribed only 0.2 per cent, British taxpayers became RBS's biggest shareholder, eventually owning 84 per cent of its shares.

Edinburgh-based Royal Bank of Scotland began its transformation from a regional retail bank in the 1980s through diversification into insurance and the acquisition of a substantial US subsidiary, Citizens Financial Group. In 2000 under the leadership of chief executive Fred Goodwin, it won a takeover battle for the significantly larger NatWest, creating Britain's second biggest bank which provided a broad range of services for personal, business and corporate customers. Rationalisation of the combined entity, with the elimination of 18,000 jobs, boosted RBS's profits and engendered an appetite for mega-deals. The acquisition greatly expanded RBS's wholesale markets activities, which in 2005 became its Global Banking and Markets division, and brought ownership of Greenwich Capital, a US lender with exposure to the then booming US sub-prime mortgage market. In September 2007, an RBS-led consortium of banks won a takeover battle for Dutch bank ABN Amro, the largest takeover in banking history. The FSA report *The failure of the Royal Bank of Scotland* (December 2011) summarised the causes as 'poor management, deficient regulation and a flawed supervisory approach'.[103] It was the outcome of a combination of seven key factors:

- capital weakness as a result of management decisions and permitted by an inadequate regulatory capital framework;
- over-reliance on risky short-term wholesale funding;
- concerns and uncertainties about RBS's underlying asset quality;
- substantial losses in trading activities, which eroded market confidence;
- the ABN Amro acquisition;
- the overall systemic crisis in which weak banks such as RBS were vulnerable to failure;
- underlying deficiencies in RBS management, governance and culture which made it prone to make poor decisions.

The immediate cause of RBS's failure was a liquidity run – following the Lehman Brothers collapse, other banks had such worries about RBS on account of suspected trading losses, exposure to losses from poor quality assets and inadequate capital, that they refused to lend to it in the wholesale interbank market. Over-reliance on short-term wholesale lending was a common factor in the failure of Northern Rock, HBOS, Bradford & Bingley and RBS, the rapid rise of many banks' use of such insecure funding being a feature of the boom years leading up to 2007.[104] RBS was highly dependent on overnight funding, a vulnerability that was much increased by the ABN Amro acquisition that was largely financed by short-term debt. RBS also pursued a deliberate policy of what Goodwin called 'capital efficiency', meaning that it chose to be lightly capitalized relative to its peers and made use of lower-quality (cheaper) forms of capital. The debt funding acquisition of the ABN Amro acquisition further weakened its capital position. 'With hindsight,' observed the FSA, 'RBS's capital before the crisis was grossly inadequate to provide market reassurance of solvency amid the

As far as the banking crisis is concerned, I was astonished that so many of the issues seemed to be the same as were visible in Equitable

general financial crisis of autumn 2008.' [105] This combination, of heavy reliance on wholesale short-term funding and high leverage (debt to equity ratio), which generated growth and profits in the short term, might well be characterised as an extreme or aggressive business model, though there were further factors that contributed to RBS's demise.

Among RBS's 'multiple poor decisions,' two proved especially disastrous. In mid-2006 a strategic decision was taken to 'aggressively' expand structured credit trading activities.[106] The structured credit markets deteriorated from spring 2007, but the ABN Amro acquisition brought further exposure to these trading book assets, which doubled during 2007. The outcome was a £12 billion loss in 2008. And then there was the ABN Amro deal, which greatly increased RBS's vulnerability. The consortium paid a top of the market multiple of three-times book value, at a time when many banks' shares were trading at book value. The bid was based on due diligence that was, commented the FSA, 'inadequate in scope and depth, and which hence was inappropriate in light of the nature and scale of the acquisition and the major risks involved.' [107] Soon the £10 billion that RBS had paid for its part of the bid was worth nothing, and Goodwin admitted to the Treasury Select Committee that the acquisition was 'a glaring mis-step'.[108] Sir Philip Hampton, RBS's new post-crisis chairman, told shareholders that it was 'the wrong price, the wrong way to pay, at the wrong time and the wrong deal.' [109] The FSA report on the RBS failure pointed to deficiencies in global regulations and flaws in its supervisory approach. So, as with Equitable, there was regulatory failure. But, like Penrose, the FSA observed that 'ultimate responsibility for poor decisions must lie with the firm... With hindsight it is clear that poor decisions by RBS's management and Board during 2006 and 2007 were crucial to RBS's failure...a pattern of decisions that may reasonably be considered poor, at the time or with hindsight, suggests the probability of underlying deficiencies in: a bank's management capabilities and style; governance arrangements; checks and balances; mechanisms for oversight and challenge; and in its culture, particularly its attitude to the balance between risk and growth.' [110] The board's decision-making over the ABN Amro acquisition was 'defective', and governance deficiencies was another similarity to Equitable. And then there was Fred Goodwin, the FSA posing the question 'whether the CEO's management style discouraged robust and effective challenge?' In particular, why had RBS persisted with the ABN Amro bid when circumstances changed? 'Hubris, evidenced by the takeover victory,' observed a former banker, 'quickly led to corporate nemesis.' [111]

Déjà vu?

In each case of failure of a British bank in the crisis of 2007-08, there was a number of factors familiar from Equitable's crisis, and in Northern Rock's case an abundance. 'As far as the banking crisis is concerned, I was astonished that so many of the issues seemed to be the same as were visible in Equitable,' said a former life assurance senior executive, expressing his sense of déjà vu as the banking crisis unfolded. 'Take arrogant management and boards that don't question enough. If you are betting the entire organisation, then have you debated it? Did the regulator learn anything? No, I don't think so. Very disappointing.'

Bank Bailouts and Banking Reform

The Equitable crisis was the trigger that set in motion the Tiner Project insurance reforms. Likewise, the £37 billion government bailout of RBS, HBOS and Lloyds TSB on 13 October 2008 precipitated a series of reviews and reports that presaged sweeping reform of Britain's bank regulation and banking industry:

Regulation

• Turner Review – on 18 October 2008, just five days after the great bank bailout, Chancellor of the Exchequer Alistair Darling commissioned Lord Turner, Chairman of the FSA, to review 'the causes of the financial crisis and to make recommendations on the changes in regulation and supervisory approach needed to create a more robust banking system for the future'. The Turner Review, published in March 2009, listed 32 'actions required to create a stable and effective banking system'.[112] It was mindful that 20 of its proposals required international agreement, but the others were in hand. The FSA would adopt a more intrusive and systematic approach ('intensive supervision'), and a more questioning and robust attitude to firms, business outcomes and risks.

Public scrutiny

• House of Commons Treasury Select Committee – in November 2008, the Treasury Select Committee announced a comprehensive banking inquiry, resulting in 17 evidence sessions plus 800 pages of written evidence.[113] Its report in May 2009 posed many questions for the authorities and the industry. 'Some of the banks have been the principal authors of their own demise,' it observed. 'The culture within parts of British banking has increasingly been one of risk taking leading to the meltdown that we have witnessed. Banks have made an astonishing mess of the financial system. However, this was a failure not only within individual banks but also of the supervisory system designed to protect the public from systemic risk.'[114]

Subsequently the Treasury Committee conducted further inquiries and produced an additional six reports on the banking crisis. It has also addressed a wide variety of other financial matters. Since 2010 it has taken on new powers. The Treasury Select Committee's enhanced prominence and power has been a notable and possibly permanent outcome of the financial crisis.

Governance

• Walker Review – in February 2009, Sir David Walker was commissioned to review corporate governance in UK banks 'in light of the experience of critical loss and failure throughout the banking system'.[115] His brief was subsequently broadened to include recommendations applicable to other financial institutions. The Walker Review was intended to complement the Turner Review on banking regulation and supervision. His report emphasised strengthened board responsibility regarding risk evaluation and management, encouragement of enhanced challenge by non-executive directors, and greater 'stewardship' by institutional investors. Its recommendations were intended to bring about significant changes in UK corporate governance from both a cultural and organisational standpoint.

Structure

• Independent Commission on Banking – in June 2010, a month after May's general election, the new Coalition Chancellor, George Osborne, announced the creation of an Independent Commission on Banking (ICB) to 'consider structural and related non-structural reforms to the UK banking sector to promote financial stability and competition'. The ICB's final report in September 2011 made recommendations to create a more stable and competitive UK banking industry.[116] Its key proposal was the 'ring fencing' of UK retail banking activities from notionally riskier investment banking business. The government accepted, in principle, many of the ICB's proposals and undertook to introduce legislation that would require compliance by banks with the measures by 2019.[117] In addition to these UK reforms there were also moves afoot in a variety of international forums focused on a range of issues, notably increased capital adequacy and liquidity standards, with the aim of putting an end to financial 'risk events'.

Lessons and Learning from 'Risk Events'

Jon Pain

...time and time again, the ability of people who are running financial institutions to properly understand and to manage appropriately the risks that they are taking on, inherent in the business they are running, falls woefully short

In recent decades, risk and risk management have developed into a science and a profession. In banking and insurance, risk executives and board level risk committees became widespread during the 2000s and are now regulatory requirements. 'The very nature of financial institutions involves risk management and risk-taking, that is the essence of what they are, whether they be banks or insurers, whatever the guise, they are risk-taking,' observed Jon Pain, a former senior FSA executive. 'So, at the epicentre of running those financial institutions is the understanding of the risk that you are taking, from a balance sheet perspective, from a business model perspective, and then from your stakeholder perspective. What the crisis of 2008 showed, and what Equitable Life showed previously, was that actually, time and time again, the ability of people who are running financial institutions to properly understand and to manage appropriately the risks that they are taking on, inherent in the business they are running, falls woefully short.' Writing on risk and 'risk events' (i.e. crises and disasters) has proliferated in recent years. What does this literature say about learning from risk events?

Learning from Disasters

Learning from Disasters: a management approach (1994), a pioneering study by Brian Toft, a professor of risk management, and Simon Reynolds, was envisaged as 'essential reading for all those involved with risk management, disaster planning and security and safety management'.[118] The authors' 'fundamental proposition' was that institutions could learn not only from their own disasters, but also from those that happened to other organisations, and thus avoid repeating them. They focused on lethal accidents, notably fires. The foremost means of learning from these events was the public inquiry, and the empirical basis of their analysis was 19 UK disaster public inquiries held between 1965 and 1978.[119] A second edition in 1997 added a theoretical framework for their empirical observations. In the preface to the third edition, published in 2005, the disillusioned authors stated their continued faith and their fundamental proposition, but observed that 'in the ten years that have elapsed since the first edition was published, little seems to have changed. Organisations continue to have disasters comparable to those that have already occurred, and it often seems to be for the same or similar reasons.' It was, they stated, the book's final edition.

Roads to Ruin

As already mentioned in this report, *Roads to Ruin; A study of major risk events: their origins, impact and implications* (2012), a report by Cass Business School commissioned by Airmic, a professional association for risk managers, featured 18 detailed case studies of high profile corporate crises across a wide range of industries. In addition to Independent Insurance, AIG and Northern Rock, which have already been mentioned, they included Arthur Andersen, BP, Cadbury Schweppes, Coca Cola, EADS Airbus, Enron, Firestone, Shell, and Société Générale. Equitable Life was a possible candidate, but it was not selected.

'Since each case study is the detailed story of a specific crisis, they also contain many lessons on the practicalities of crisis management and planning,' the report observed. 'They provide a valuable and extensive opportunity to learn painlessly from the misfortunes of others, and so have enabled us to compile a series of observations on good and bad crisis management.' Through evaluation of the case studies, the report identified seven broad categories of 'underlying risk' that gave rise to corporate crises:

- Inadequate board skills and inability of non-executives to exercise control.
- Board blindness to inherent risks, such as

Professor Chris Parsons

In every case the failings were essentially at board level

...there was actually precious little evidence that anyone had learned... from previous disasters, which were very much the same

...lessons unlearned are experience squandered, with a potentially avoidable cost of some sort to someone

risks to the business model or reputation.

- Inadequate board leadership on ethos and culture.
- Defective internal communication and information flow.
- Organisational complexity and change.
- Inappropriate incentives, both implicit and explicit.
- 'Glass Ceiling' effects that prevent risk managers from addressing risks emanating from top echelons.

In relation to Equitable, the first two points about governance plainly apply. 'In every case the failings were essentially at board level,' observed Professor Chris Parsons, one of the authors. 'There are other causal factors, but it was decisions taken, or not taken, at board level, which were really key to the result.' Better governance and an enhanced role for risk professionals were the report's core recommendations:

The important lessons from this research are related to the need for boards, particularly non-executive directors, to be more effective in their approach to risk management, seek full information and ask challenging questions about the underlying risks that we identified. We have concluded that four important developments are necessary if boards are to effectively address these important risk issues:

1. *The scope, purpose and techniques of risk analysis and management will need to be re-thought in order to capture risks, such as those we have identified, that are not routinely covered by current approaches.*
2. *Risk professionals may need to extend their skills so that they become competent to identify, analyse and discuss risks emerging from ethos, culture and strategy of their company and the activities and behaviour of their leaders.*
3. *The role and status of risk professionals will have to change so that they can safely evaluate, report and discuss all that they find on these underlying risks at all levels, including board level.*
4. *Boards, and particularly the chairman and non-executive directors, need to recognise the importance of risks that are not captured by current approaches – they also need to focus on how to ensure missing risks are captured.*

Many of the risks we have highlighted are inherent in every organisation. Unrecognised and unmanaged, these underlying risks pose a potentially lethal threat to the future of even the largest and most successful businesses.

Boards, particularly chairmen and non-executive directors, have a large, important blind spot in this dangerous area. Without board leadership, these risks will remain hidden because only boards can ensure that enough light shines on these hard to see risks.

'In the cases we looked at there was actually precious little evidence that anyone had learned from it, and that any formal steps had been taken...that they had actually learned from previous disasters, which were very much the same,' said Parsons. 'One of the cases we looked at was just a repeat of a case that had happened 20 years earlier... They appeared to make exactly the same mistakes as the first time round. You would think it would be possible to put in place processes of some sort to deal with it. Maybe it's a generational thing. You get the cycle, the repeat story, and that always happens. There is always a call for more regulation and more control and so forth. Then very little happens for a while, and then people say "why are we spending all this money, it's disgraceful." And then the cycle repeats itself.'

Violent accidents and corporate catastrophes are invariably followed by post-mortem inquiries that identify the causes and suggest lessons. Yet, in practice, learning lessons is very difficult, even in the same company and same industry. But lessons unlearned are experience squandered, with a potentially avoidable cost of some sort to someone.

Lessons and Learning from Equitable beyond Insurance

Plainly the insurance industry and regulator learned lessons from Equitable, setting off the Tiner reforms. But as the biggest and gravest crisis in the modern history of UK pensions and insurance, the causes and consequences of Equitable's crisis also held lessons of various sorts for a variety of others. So who learned what, and who did not learn, from Equitable?

I don't remember being kept awake at night reading across the lessons from Equitable Life

British banks – not much learning there

Did British banks or bankers learn from Equitable's very public crisis? Plainly the four banks that failed did not, notwithstanding that the factors that resulted in them ending up wholly or partly in public ownership were significantly similar in some combination to those that caused Equitable's crisis. 'I remember talking about the features that had led to it, and it's interesting when you see the events of the next ten years that some of those features are still with us,' said a banker, 'but Equitable was not at the centre of our radar.' 'I think there is a degree of institutional blind spots, where people believe that although it has happened over there it can't happen to us,' observed a regulator. 'And therefore, despite what actually happened, you have a prevailing thought that, "actually, well, our risk management, our approach to how we run our business, is inherently different." And, of course, unfortunately, that is not always the case.' Senior bankers at British banks that did not need government support – Barclays, HSBC and Standard Chartered – seemed equally oblivious to Equitable's crisis as holding lessons for bankers. 'I don't remember being kept awake at night reading across the lessons from Equitable Life,' commented a senior executive at one of them. 'Truthfully, it wasn't a major thing in my banking circles,' said another. 'There was a sense of superiority in the banking system at the time. A sense of, yes, well, an extremely old mutual, with mutual-style governance, has sleep-walked into a problem, but we as thrusting bank managers would never do the same thing. There was no: "Oh my God – fundamentally their risk assessment and control processes are the same as ours – and they've walked themselves straight into this problem, so what would ours do?"'

Jim O'Neill

...one industry really isn't that good at learning from another industry

Why didn't bankers learn lessons from Equitable? 'Stating the obvious,' said Jim O'Neill, Chairman of Goldman Sachs Asset Management, 'I guess that generally one industry really isn't that good at learning from another industry.' 'Equitable was different because it was a different industry, so I am not sure that we would have drawn huge amounts of lessons,' observed a top banker. 'And secondly, it clearly had a problem that was unique. As I recall, nobody else had guaranteed products to the point where they brought the institution down.' 'There is an argument that maybe not enough is done to communicate generic lessons across the whole of the financial system,' said another. 'There is a slight tendency, if you are in banking and if something goes wrong in insurance, to say that is nothing to do with me, and vice versa.'

'Lessons were learned in the life insurance industry, but I don't think there was any broader translation into retail banking. It's not obvious that there was,' recalled a bank insurance professional. 'It's not surprising because although banks may sell insurance, there's no great understanding of insurance in banks at all really. Life assurance is far too complex – why would I need to know about it, what's it got to do with me?' 'I think Equitable was very much seen as a big accident of its own making, rather than the industry. There wasn't a big connection because Equitable was a sort of standalone life company,' commented Gary Hoffman, head of Barclay's life business at the time. 'So there was not a big read across into

Alex Brummer

Labour regarded Equitable as a posh person's institution... Whereas when it was their own people queuing outside Northern Rock, they moved like lightning

The government hoped that the Equitable issue would fizzle out, but they reckoned without EMAG

the banks. Whereas if it had been a life company owned by a bank there would have been. If it had been Barclays, there would have been read across.' But another banker was sceptical. 'Possibly, but I'm not totally convinced. I think the insurers in the commercial banks are still insurers. The bancassurance model has never really got massive traction in the UK.'

Did banking regulators and supervisors learn from Equitable or the insurance reforms it triggered? 'At the time the really sick child in the house was insurance and the sibling, which was banking, was not posing particular problems,' said John Tiner, who in 2003 became FSA chief executive. But, aware at the time that insurance regulation had 'leap-frogged' its banking counterpart, he continued 'what we should have done then is see if we could improve banking regulation. But that was pretty much out of our hands. Whilst insurance industry regulation was heavily established at the national level, in banking it wasn't. It was the Basel Committee.'

'It certainly wasn't a decisive event in terms of changing the mood,' said a former bank chief executive. 'It didn't go bust, it was confined,' observed Angela Knight. 'It was a big disaster, but it was handled. It was confined and it didn't turn out to be systemic. My personal feeling is that the crisis of the past six years was so widespread that the lessons will be retained until the point at which the last man standing has retired. It was too big. The lessons of Equitable were much more focused, and they didn't bring an economic downturn.'

While banks and bankers apparently learned little, or nothing, from Equitable, there were others who did learn in a variety of ways including:

Policyholders – outrage and self-help

Naturally, Equitable's 1.5 million policyholders were horrified by the revelations of its financial problems. Having saved responsibly for their retirement, their pensions expectations were in many, many instances thoroughly undermined. In summer 2000, following the House of Lords ruling, the Equitable Members Action Group (EMAG) was formed 'to represent common interests of all classes of policyholders with an interest in the ELAS with-profits fund'.[120] Shock turned to anger and frustration, not only with Equitable's then management and board, both as regards the origins of the crisis and the management of the debacle, but also with the government's exercise in prevarication through the series of official inquiries that lasted a decade. What was at stake was what role regulatory failure had played in the catastrophe and what the policyholders involved would receive in compensation. The Barlow Clowes scandal of the early 1990s appeared to provide a hopeful precedent. In that episode, a finding of regulatory maladministration resulted in 150,000 pensioners who had lost £150 million receiving full compensation from the government.[121] But the potential bill for Equitable was much bigger and 'Gordon Brown, first as chancellor and then as prime minister, helped to ensure that that issue was consistently kicked into the long grass.'[122] 'I think this was a political thing,' said the *Daily Mail*'s Alex Brummer. 'Labour regarded Equitable as a posh person's institution. If a load of rich people lost some money, so what? Serves them right.' 'The Treasury has sought to portray Equitable policyholders as rich, but this is highly misleading,' observed EMAG.[123] It pointed out that the average fund of the half million personal pension savers would generate a weekly income of just £70, and the average fund of the one million group of Additional Voluntary Contribution (AVC) savers was only £4,000. Policyholders were outraged when the government promptly provided full guarantees for depositors in 2007 during the banking crisis. 'The whole delay was because they didn't really care about these people,' continued Brummer. 'Whereas when it was their own people queuing outside Northern Rock, they moved like lightning.'

The government hoped that the Equitable issue would fizzle out, but they reckoned without EMAG and the intense interest of the financial press. Paul Braithwaite, the driving force who has steered EMAG since its inception in 2000, said, 'We have been effective because of the anger felt by policyholders, and the support of a handful of MPs. EMAG's success is attributable to a talented board and being funded by subscription from its dedicated members.' It became one of the most formidable action groups in recent history. 'It really started to hot up in 2004 when the government tried to bury the Penrose Report,' said Braithwaite.

...there are still very angry and bitter policyholders who haven't yet gone away

Following publication of the Penrose Report, working with MPs, they ensured that the Parliamentary Ombudsman conducted a 'proper study' of the regulation of Equitable. Furthermore, they took the matter to the European Parliament, resulting in a 385-page report in May 2007 that 'strongly recommended' government compensation for policyholders.[124] Many British politicians were sympathetic to the case for compensation, and some, for instance Vince Cable, were outspoken supporters.[125] Following the Parliamentary Ombudsman's second report, which found regulatory maladministration and advocated government compensation, EMAG and its supporters secured its inclusion in the manifestos of the Conservative and Liberal Democrat parties at the 2010 general election. The outcome was the £1.5 billion compensation award announced in October 2010. Nevertheless, as one of them put it, 'there are still very angry and bitter policyholders who haven't yet gone away.'

Professor Geoffrey Wood

How can you stop a chief executive being overbearing? You can't make it illegal

Boards, staff and investors – hubris alert

'How can you stop a chief executive being overbearing?' wondered Professor Geoffrey Wood, economist and consultant. 'You can't make it illegal.' 'What we don't want is for institutions to appoint patsies as CEOs,' said an insurance industry executive. 'We want leaders, people who have imagination, have a risk appetite, some entrepreneurial flair. We don't want a bunch of bureaucrats running companies. So there has got to be a way of allowing all that entrepreneurial activity to take place but within some sort of controlled environment. That links back to Equitable.' But a problem may arise if the controls – governance and regulation – fail and dynamic leadership becomes 'idiosyncratic and autocratic' dominion by a powerful executive, as manifested repeatedly at troubled financial institutions including Equitable Life, Independent Insurance, AIG, Northern Rock, HBOS and RBS, and US investment banks Lehman Brothers and Bear Stearns. On Bear Stearns' last day as a public company in March 2008 staff lined up outside the bank's headquarters to view a painting of chief executive Jimmy Cayne with the caption: 'Hubris – thy name is Jimmy!'[126]

The financial services industry is particularly vulnerable to hubris

'The financial services industry is particularly vulnerable to hubris,' observed economic commentator John Kay, 'because sections of it are not very competitive, and randomness plays a large role in the outcome of speculative transactions. It is therefore particularly easy for those who work in financial institutions to make the mistake of believing that their success is the result of exceptional skill rather than good fortune. What is more natural than to believe that extraordinary talent will find pots of gold under other rainbows?' [127]

Lord David Owen's interest in the conjunction of medicine and political leadership has led him to explore hubristic behaviour among politicians in scholarly papers and his books *In Sickness and In Power* (2008) and *The Hubris Syndrome* (2012).[128] He has postulated that: '"Hubris syndrome" is seen as an acquired condition...The key concept is that hubris syndrome is a disorder of the possession of power, particularly power which has been associated with overwhelming success, held for a period of years with minimal constraint on the leader.'[129]

Nick Bouras, Professor Emeritus of Psychiatry at King's College London, has said since the financial crisis there has been an upsurge of interest in hubristic leadership and the hubris syndrome as a factor in bank failures. He and Lord David Owen are founders of the Daedalus Trust established to promote research in the field.

Personal encounters with the management of Equitable Life and Northern Rock led the *Financial Times*'s Martin Dickson to propose a 'Hubris Index' as a tool for investors:

Successful business people – indeed, successful people in any walk of life – need a lot of confidence. But there comes a point where self-belief can tip over into a dangerously blinding arrogance – and it can apply to institutions as well as individuals.

Over the past 20 years I have had the pleasure (and occasional displeasure) of meeting hundreds of bullish leaders on both sides of the Atlantic. But two lunches with British companies – one in the late 1980s, and the other about five years ago – have always stood out in my memory for the quite extraordinary degree of certainty displayed by their management teams. Smug hardly describes it. Each seemed almost giddy with the cleverness of its business model.

The first was Equitable Life, the life assurer eventually brought low by an adverse legal ruling and its strategy of distributing surpluses instead of building up reserves. The second was Northern Rock, with its unusual reliance on short-term

John Tiner

Sadly history suggests you need a crisis for things to happen

wholesale financing.My impressions were superficial and extremely subjective, and gave me no real idea that there might be any problem with their models. But arrogance is a classic cause of business failure, preventing you thinking flexibly or seeing that you might be wrong. And both Equitable Life and Northern Rock developed reputations for being mighty pleased with themselves.

There is truth in the celebrated dictum of Intel co-founder Andy Grove that 'only the paranoid survive'. It would, therefore, be helpful to investors if someone could come up with a methodology to quantify degrees of boardroom smugness that is more rigorous than vague post-prandial impressions (along the lines of: 'What a nauseatingly self-satisfied toad'). Components could include analyses of chief executives' language (number of 'I's'relative to 'we's'; use of words such as 'certain', 'dominant', 'winning', 'new paradigm', and 'unchallenged') and surveys of how the company acts towards suppliers, competitors, customers and investors…bring on the Hubris Index, a boon for short-sellers everywhere.[130]

Management – 'caveat vendor'

'If you use the word "guarantee" that is exactly what it is,' said a regulator. 'Don't come back years later as Equitable did and say, well, we did not actually mean that, or we did not mean that in these prevailing circumstances.' 'De facto, the customer is always right,' observed a banker. 'It doesn't matter what you have told them, if you told them something that the average man wouldn't fully understand you didn't really tell them. Beauty is in the eye of the beholder. It's caveat vendor.'

Regulators – don't waste a good crisis

'Sadly history suggests that you need a crisis for things to happen', observed John Tiner. The collapse of Barings in 1995 resulted in a review of banking supervision (conducted by Tiner) and reforms that 'for the first time ever moved banking regulation out of the old world into a risk-based world.' But insurance regulation remained 'somewhat antiquated'. Then came the Equitable crisis. 'The changes we made between 2001 and 2004 were absolutely critical, and absent the Equitable you have to wonder if they would have happened – I don't think they would,' said Tiner. 'There would have been no burning platform for me as the CEO or for my board to say: "We have to do that." Because you have always got to make a cost benefit case, and basically you couldn't have done it.'

Conclusions

Many of the same factors that were seminal to the Equitable crisis were present in the bank failures of the 2007-08 financial crisis

Inquiry after inquiry, report upon report, point to the same, consistent fault lines

The foremost finding of this research is the absence of learning by bankers or bank regulators of lessons from the Equitable crisis

...now is the time to get this wired into the new regulators' modus operandi

Board governance failure is a common feature of the Equitable and the crisis-stricken banks

The starting point for this project was the question: *Did Anyone Learn Anything from the Equitable Life?* Lessons were learned in insurance, but there was no read across to banking by the industry or the regulator. In fact, many of the same factors that were seminal to the Equitable crisis were present in the bank failures of the 2007-08 financial crisis. Inquiry after inquiry, report upon report, point to the same, consistent fault lines: hubristic executives, weak board governance, risky business models, product complexity and opacity, and regulatory shortcomings. These factors were starkly evident in the Equitable crisis well before the financial crisis that began in 2007, and appear to be going on today. Plainly it would be desirable that such crises should be avoided in future, or their impacts minimised. Does the evidence and analysis provide pointers as to how this might be achieved?

Learning from the misfortunes of others
The foremost finding of this research is the absence of learning by bankers or bank regulators of lessons from the Equitable crisis. This leads to the proposition that, had such learning from Equitable taken place, the impact of the banking crisis of 2007-08 would have been moderated, with obvious benefits to taxpayers and the economy, not to mention the banks themselves. While the evidence points to the difficulty of learning lessons from one sector by another, plainly there are potential benefits from so doing. Certainly there are different liquidity, solvency and risk issues for different sectors, but 'it's a different industry' may mean a learning opportunity missed with terminal consequences. Interviewees mentioned reactive internal reviews following some high-profile financial catastrophes, notably the losses inflicted by the rogue traders at Barings and Société Générale, along the lines of 'could this happen to us?' There was also the project by European Economic Area insurance supervisors to identify and learn from insurance company failures and near failures. Useful as they may have been, they were reactive, one-off exercises.

Suggestion:
The development of a formal and continuous process of learning from crises within sectors, across sectors and internationally. This sounds like a job for the regulators, and, once devised, implemented by firms. As Cass Business School's Chris Parsons, author of the *Roads to Ruin* report observed: 'You would think it would be possible to put in place processes of some sort to deal with it.' With the new financial regulatory framework currently being developed in the UK, now is the time to get this wired into the new regulators' modus operandi.

Board governance – need for a new model
Board governance failure is a common feature of the Equitable and the crisis-stricken banks. Penrose was scathing about Equitable's corporate governance and their non-executives who he found 'did not understand the risks to which the Society was exposed' and were 'incompetent to assess the advice objectively and challenge the actuaries'. His observations could have applied just as well to bank boards, with inadequate technical skills on the part of non-executives, ineffective control, and board blindness to inherent risks being recurrent shortcomings.

Sir David Walker addressed the issue of how to get more effective 'challenge' of executives and greater command of risk by non-executive directors in his report on corporate governance, advising that it will 'require a materially increased time commitment from the NED group on the board overall for which a combination of financial industry experience and independence of mind will be much more relevant than a combination of lesser experience and formal independence. In all of this, the role of the chairman is paramount, calling for both exceptional board leadership skills and the

Finding somebody from a board perspective who effectively can exercise an oversight process over a large global complex financial institution is a tall order

What the expectations are, and what the role spec is, still haven't been aligned

It's a full-time role – but we are still locked in the old paradigm where it is a part-time job they measure in hours or days a year

For complex financial service businesses, a new governance model of some kind needs serious consideration

Devised by bank 'rocket scientists', their structured products...surpassed the comprehension of not only many directors but also of banks' risk models

Where were the people that said, "hold on, that is not right"?

ability to get confidently to grips with major strategic issues. With so substantial an expectation and obligation, the chairman's role in a major bank board will involve a priority commitment leaving little time for any other business activity.' [131]

In fact, Credit Suisse has introduced a full-time chairman alongside a full-time CEO. 'The chairman at Credit Suisse is a full-time independent non-executive, it's the only job he has,' a former senior regulator pointed out. 'That means that he has got the time to be moving around inside the bank, talking to people, finding out what people at lower levels are saying about the hierarchy, what's going on... because he's got the time. He does it in a way that doesn't get in the way of the authority and the standing of the CEO. I think in a systemically important institution, whether it's a bank or insurance company, that's a very good model.'

Conventionally, non-executive directors (NEDs) devote some 20 to 50 days a year to the role. But large, complex financial services organisations have a multitude of rapidly changing facets of the business that challenge a comprehensive command by the full-time executives, let alone part-time non-executives. In reality, many non-executive directors have been able to bring to the board little more than common sense. 'Finding somebody from a board perspective who effectively can exercise an oversight process over a large global complex financial institution is a tall order,' said another ex-regulator. 'And then you ask them to do that on a part-time basis. What the expectations are, and what the role spec is, still haven't been aligned. It's a full-time role – but we are still locked in the old paradigm where it is a part-time job they measure in hours or days a year.'

The near impossibility of fulfilling the role of NED at a large complex systemically important financial institution is widely recognised by potential candidates. Many interviewees stated that they would not accept an invitation to join such a board in a NED capacity because of the reputational risk. 'If you've got a choice of serving on this company board or that board,' said Angela Knight, 'you're probably going to choose the one that doesn't actually look like you're going to be reputationally crucified if you get it wrong.' In fact, as several interviewees pointed out, Equitable's crisis marked the beginning of the recognition of the impossible role and reputational risk of serving as a NED at a financial institution. Moreover, even relatively rare candidates with adequate technical grounding would need constant training to keep abreast of rapidly evolving methods involving an extensive and intensive commitment. 'If you want to be a NED, join Diageo not a bank,' was one interviewee's advice.

Observation:
Interviewees repeatedly mentioned banks' corporate governance issues and the problems with the current model. For complex financial service businesses, a new governance model of some kind needs serious consideration.

Product complexity and opacity

The traditional with-profits life assurance policy was a highly opaque and complex product devised and managed by the industry's high priests – the actuaries. At Equitable, the non-executive directors were incapable of following their mathematical convolutions and thus of effectively monitoring or controlling the leading executives who, boy and man, were actuaries. Thus they failed to spot the over-allocation of bonus and over-payment on claims, which put Equitable towards the top of the league tables but critically weakened its financial position.

Complex and opaque financial products proliferated in the years before the financial crisis. Devised by bank 'rocket scientists', their structured products, such as credit default swaps, surpassed the comprehension of not only many directors but also of banks' risk models and, so it would appear, regular professional scepticism. 'Where were the people that said, "hold on, that is not right"?' wondered a senior banker. 'Where were all the academic and mathematical departments? The risk analysts? The rating agencies? Where were the regulators? All those – stuffed full of very bright people – why did none of them say: "Hang on a second"? I genuinely cannot say why of all the people in the world who do this sort of stuff – the modelling and the reasoning – why there wasn't even a 10 per cent proportion who cast theoretical doubt on it?'

Suggestion:
There is no escaping mathematically complex and opaque financial products in the modern financial world. People are well aware of the need for yet more

sophisticated risk models, risk awareness and product regulation. But one banker also suggested a simple low-tech stratagem. He said, 'When the banks go for approval, the regulator should say: "Go away and write it down on one side of a bit of paper that I can understand." If they can't, the product is too complex.'

Business models – 'too good to be true' pre-mortems

Pondering lessons from Equitable, several interviewees observed that the Society's historic business model illustrated the adage: if it seems too good to be true, it probably *isn't* true. 'It is true of absolutely everything,' said a banker. 'How could you make all this money...up to the run of 2007? It's not credible.' 'If you go back to BCCI, when they were able to offer a better rate than anyone else,' said another, 'or if you look at the huge profits made up to the crash, or all the people who thought they had struck it rich when they could buy and sell junk bonds to each other; if they had only paused to reflect, and asked themselves "why is this the case?" Maybe, they might have avoided some of the problems they got.'

...profits you don't understand are more dangerous than losses you do

'The First Commandment of risk management – the most important one in my book – is that profits you don't understand are more dangerous than losses you do,' observed one retired FSA executive. 'It's very difficult to do, but without doubt it is the overriding issue in my mind that prevents disasters. You ask questions. Why is it all too easy making money? If there is a fraud, people will try to cover it up by pretending they are doing something different. And if it is not a fraud but a whole market going the same way, then it's creating a dangerous bubble and a reversal could be very painful.'

Suggestion:

'In all financial crises when you do a post-mortem it's not usually too difficult to see what went wrong, and an awful lot of it is bad judgment and human error,' commented a politician close to the 2007-08 banking crisis. 'So sometimes it is an idea to have a pre-mortem when everything is going OK, and ask yourself "why is it going OK?" And if it is going OK for good reasons then carry on. Or if it is not, *stop*.'

Out-of-control executives

The Penrose report on Equitable laid blame for its disaster squarely at the door of its senior executives and directors, especially Roy Ranson, its 'idiosyncratic and autocratic' actuary and subsequently chief executive, who has been described as 'a domineering figure who brooked no dissent.' As noted earlier, hubristic conduct by senior executives was a problem at a remarkably high proportion of major financial institutions that got into serious trouble – RBS, Northern Rock, HBOS, AIG, Lehman Brothers, Bear Stearns, Independent Insurance, etc.

...monitor closely the possible onset of hubristic behaviour

Of course, self-confidence and strong leadership go with the role of chief executive and are usual character traits of an effective candidate. So is it, as advocates of the Hubris Syndrome contend, that it is the exercise of power itself that leads to a change in personality? Given the damage done by wrecked financial institutions it would seem prudent to monitor closely the possible onset of hubristic behaviour.

Suggestion:

As academics are wont to say, this subject plainly needs further research (and, naturally, research funding). What is the incidence and development of hubristic conduct of executives in the financial services industry? Is there a relationship with crises? As an interim precaution, the high correlation should be brought to the attention of bank directors and regulators to encourage scrutiny for tell-tale signs. The devices suggested by Martin Dickson for the construction of his 'Hubris Index' might serve as a starting point for such scrutiny.

Regulation – don't bet the bank

A good judgment in banking comes from experience, but the trouble in banking is that most experience comes from earlier bad judgment

Banking is about the management of risk, and taking risks means making mistakes. Bank of England governor Gordon Richardson was wont to say: 'A good judgment in banking comes from experience, but the trouble in banking is that most experience comes from earlier bad judgment.' 'It's actually useful to have a minor failure,'observed a senior banker. 'It sounds perverse, but human beings can't remain fully prepared passively for very long periods of time and you get complacent. If nothing goes wrong, you think: "Do I really need to keep testing it so much? Do I really need to be so careful? When did it last go wrong?" Then you accept a bit more risk.' 'When I became chairman of the Morgan Stanley global risk committee,' recalled Sir David Walker, *No matter how different the latest frenzy or crisis always appears, there are usually remarkable similarities with past experiences*

"This time is different"... are the four most costly words in the English language

Simple, and fitting for a 250th historical anniversary, study financial history

'the chairman told me: "We are tolerant of mistakes – provided they've not been made before." This is it precisely – did we learn from the experience? And the answer in financial services is generally "no".'

'You have to assume that, given you cannot make a return without some risk, it follows that mistakes will always occur because nobody gets everything right,' said a former top regulator. 'So the job of the regulator isn't to stop the management making bad decisions, because there is a certain inevitability to the fact that bad decisions get made because they are the flip side of good decisions and good decisions are needed to make returns. What you have to do is set the boundaries so that the consequences of a bad decision have a relatively low probability of busting the company and certainly have a very low probability of adversely affecting the system as a whole. Obviously, what was wrong pre-2007 for the banks was that the boundaries were set far too wide.'

Observation:
The new international standards, *Basel III* for banking and *Solvency II* for insurance, certainly impose enhanced solvency and liquidity requirements and set other boundaries more tightly. Plainly this is sensible. But the creative ingenuity of the financial services industry down the decades, including Equitable's GARs and 'full distribution' business model, means that one way or another, financial firms and systems find ways of taking on additional risk to make greater rewards. We have not seen the last financial crisis.

'This Time Is Different'

The Equitable Life crisis and the banking crisis of 2007-08 were additions to an already long list of financial crises of one sort or another. The aftermath of the banking crisis saw the timely publication of *This Time is Different: eight hundred years of financial folly* by US economists Carmen Reinhart and Kenneth Rogoff. Their book is a long-term quantitative study of financial crises in their various guises. 'Our basic message is simple,' they stated. 'We have been here before. No matter how different the latest frenzy or crisis always appears, there are usually remarkable similarities with past experiences from other countries and from history. Recognising these analogies and precedents is an essential step toward improving our global financial system, both to reduce the risk of future crises and to better handle catastrophes when they happen.'

Since there have been so many financial crises in the past, why don't people learn from history and avoid repeating past mistakes? Because of the 'this-time-is-different' syndrome. 'The essence of the this-time-is-different syndrome is simple,' wrote Reinhart and Rogoff, 'It is rooted in the firmly held belief that financial crises are things that happen to other people in other countries at other times; crises do not happen to us, here and now. We are doing things better, we are smarter, we have learned from past mistakes. The old rules no longer apply.' [132] The syndrome applies to firms as well as financial systems. The conduct of banks ahead of the 2007-08 financial crisis fits the syndrome, as does Equitable's historic business model. In fact the phrase 'This Time is Different' was coined by Sir John Templeton, a legendary fund manager, who observed that they are 'the four most costly words in the English language'. And so it proved for the banks and for Equitable Life.

Suggestion:
Simple, and fitting for a 250th historical anniversary, study financial history.

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