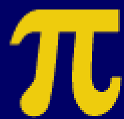

An Assessment of the Adequacy and Objectivity of the Information Provided by the Board of the Equitable Life Assurance Society in Connection with the Compromise Scheme Proposal of 6 December 2001

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http://www.pensions-institute.org/reports/equitablelife_DBreport.pdf
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Terms of Reference

To assess whether Members of the Equitable Life Assurance Society have been provided with adequate and objective information by the Board concerning the Compromise Scheme Proposal of 6 December 2001.

Notes:

1. The Report is an independent report under Part 35 of the Civil Procedure Rules on Experts and Assessors.

2. The Report will only be available at http://www.pensions-institute.org/reports/equitablelife_DBreport.pdf or http://www.emag.org.uk.

3. The Report is not intended to constitute advice to policyholders and the author will not engage in any correspondence with policyholders in connection with the Report.

4. The Report was written to a very tight deadline, and should be considered preliminary.

Key Findings

I have been asked to assess whether members of the Equitable Life Assurance Society have been provided with adequate and objective information by the Board concerning the Compromise Scheme Proposal of 6 December 2001. I have undertaken this assessment from a **financial economics** perspective rather than from a **legal** or **actuarial** perspective[1]. My key findings are as follows.

I begin with the principal aspects of the background to the Compromise Scheme Proposal:

1. Between 1957 and 1988, the Equitable Life Assurance Society (ELAS) offered guaranteed annuity rates (GARs) to its with-profit policyholders (these GARs applied to single-life fixed annuities only). Those policyholders who accepted the guarantees did not pay extra for them. For the whole period between 1957 and 1988, the guarantees had no *intrinsic value*, since the GARs were much lower than current market annuity rates (CARs); it was only after 1993 that the GARs began to have an intrinsic value as CARs fell below GARs. However, the GARs also had a *time value* which ELAS failed to price.
2. In addition, the GARs were subject to interest rate and mortality risks which ELAS did not explicitly hedge, but which it believed it could manage by 'discretion'. In contrast, other life offices chose to reinsure these risks or, alternatively, bought out GAR rights or capped them and used an orphan fund to run them off.
3. The discretion took the form of a differential final bonus policy, whereby those GAR policyholders who opted to take GAR pensions when they retired received a lower final bonus than those GAR policyholders who elected to take their benefits in a different form, such as a joint-life annuity. ELAS believed its discretion was lawful under its Articles of Association. Some policyholders complained that the differential final bonus policy nullified the effect of the guarantees. A House of Lords ruling on 20 July 2000 accepted this argument and obliged ELAS to honour those guarantees which were valued at the time at £1.5bn. However, since ELAS is a mutual organisation without shareholders, the Board of ELAS argues that the only source of funds

[1] To illustrate the difference between these approaches, take the concept of 'fairness'. Financial economists use a market-based approach to fairness. In answer to the statement 'I am being asked to take on a risk that I cannot diversify away', a financial economist would ask 'Is the market compensating you adequately for bearing this risk?'. If the answer is NO, then a financial economist would say that you are not being treated fairly. In contrast, lawyers use a rules-based approach to fairness. A lawyer will seek to determine whether the rules behind any contract have been fairly applied. Actuaries, on the other hand, use a notional concept of fairness and would argue that you are being fairly treated if you receive the notional value of benefits that you have been promised. In the case of Equitable Life, the lawyers at the House of Lords did not accept that the allocation to policyholders on the basis of notional asset share which Equitable's actuaries believed to be fair was consistent with the Society's rules. Financial economists would argue that different classes of policyholder had not been fairly treated because they had not been compensated adequately for the risks that they had assumed.

available to honour the guarantees is the general with-profit fund which includes non-GAR policyholders.

4. In consequence, the non-GAR with-profit policyholders have been gravely misled by their participation in the ELAS with-profit fund, especially those who joined after January 1994. The main principle underlying the House of Lords ruling was equal treatment, but equal treatment could never be achieved while both GAR policyholders and non-GAR policyholders were members of the same with-profit fund. Other life offices separated the funds of GAR and non-GAR policyholders.
5. The reason for this is that a guaranteed annuity is a 'fixed' rather than a 'with-profit' product and it is therefore highly inappropriate from a risk management perspective to offer products with guarantees within a with-profit fund. The purpose of a with-profit fund is for the claims against the fund to be flexible and to rise or fall in line with the underlying assets in the fund, but in a less volatile fashion.
6. Guaranteed annuities, on the other hand, are options that when exercised become fixed claims on the fund. A guaranteed annuity can be interpreted in financial engineering terms as an *interest rate put option* on a stream of payments.
7. The fact that some members of the same with-profit fund had a GAR while others did not violates a key principle underlying a pooled fund, namely that all members expect to be allocated the same rate of return.
8. Since ELAS did not hedge its insurance risk exposure to the GAR policyholders, it, by default, transferred the burden of providing this insurance to the non-GAR policyholders. The non-GAR policyholders became unwitting providers of insurance to the GAR policyholders. ELAS caused non-GAR policyholders (without their knowledge or approval) to write interest rate put options which are held by GAR policyholders. The non-GAR policyholders received no premium for issuing these options, thereby violating the first principle of sound insurance, namely that the insurance provider collects sufficient premiums to pay for any likely claims.
9. In a competitive insurance market, insurance providers expect to break even, so it is arguable that the value of the premiums 'owed' by the GAR policyholders to the non-GAR policyholders for providing the insurance is also equal to the difference between the uplifts, namely 15 percentage points.
10. The non-GAR policyholders have a very strong case for arguing that their funds should have been separated from the very start from the funds of the GAR policyholders, although the House of Lords ruled that GAR policyholders' funds could not be ring-fenced from those of non-GAR policyholders.
11. The House of Lords ruling on 20 July 2000 (on ring fencing) merely recognised formally the position that the non-GAR policyholders had been placed in as unwitting providers of insurance

to the GAR policyholders. Yet the Board continued to accept new non-GAR policyholders into the single with-profit fund even after the House of Lords ruling.

12. The difference in interests between GAR and non-GAR policyholders extends beyond that between an insurance provider and an insurance taker, it is also reflected in different appropriate investment policies for the with-profit fund. To meet the interests of GAR policyholders who have a bond-type product, the fund should have been heavily invested in bonds, rather than equities from the very beginning. Leaving liabilities unhedged is potentially very risky and violates the second principle of sound insurance, namely that assets should be selected to match liabilities as closely as possible. However, this asset allocation is incompatible with the interests of the non-GAR policyholders who wish to have a high equity weighting for the fund.
13. ELAS also had to attract sufficient new non-GAR policyholders to help it bail out the GAR policyholders if equity performance was inadequate. So after 1988 when GARs ceased to be offered, the ELAS with-profit scheme began to take on the characteristics of a Ponzi scheme.
14. Ponzi schemes have the following characteristics:
    - The high returns achieved by the initial members of such scheme are paid in part out of the contributions of the later joiners
    - They require an increasingly rapid inflow of new members to sustain themselves
    - They end abruptly when the inflow of new members ceases
    - Those who join very late in the scheme's life lose a lot of money.

    These are all characteristics shared by the ELAS with-profit scheme.
15. The effect of the House of Lords ruling was to legitimise this Ponzi scheme, since their Lordships ruled that the funds of the non-GAR policyholders could not be separated from those of the GAR policyholders.
16. The non-GAR policyholders, despite selecting a with-profit equity-dominated fund, have ended up with a bond-dominated fund with little upside potential in terms of future bonus additions.
17. The closure of the fund to new members has turned the scheme from an ongoing scheme into a run-off scheme. Without a regular inflow of new and younger members, who bring the joint benefits of immediate contributions but distant maturing liabilities, the investments will have to be managed principally for the purpose of delivering pension payments rather than for generating growth. This massively reduces future investment flexibility. This lack of flexibility is reinforced by the present low level of free assets.
18. The combined effect of all these factors was to turn the fund from a with-profit fund heavily invested in equities but with smoothing possibilities into a managed fund, but with little realistic upside potential.
19. The non-GAR policyholders have therefore suffered a triple whammy:

- An insurance claim against them from the GAR policyholders in return for which they have received no insurance premiums
- An investment fund, dominated as it is by bonds, which looks very unlike the with-profit equity-dominated fund they believed they were buying into, and
- An end to the possibility of new members joining to help spread the burden that they face.

20. On the basis of this financial economics interpretation of the events leading up to the CSP, the key decisions made by previous Boards of ELAS are these:
    - They offered a non-with-profit product within a with-profit fund
    - They accepted a risk exposure by offering GARs that they neither priced nor hedged adequately
    - They subsequently tried to nullify the effect of their commitment to GAR policyholders via a differential final bonus policy
    - When this failed, as a result of the House of Lords ruling, they transferred the commitment to honour the guarantees to non-GAR policyholders
    - They chose an asset allocation for the with-profit fund that is suitable neither for delivering the GAR product nor for meeting the interests of the non-GAR policyholders
    - They closed the fund to new members.

    In financial economics terms (if not in legal term), these constitute substantial breaches of the agreements both implicit and explicit that the previous Boards had with both their GAR and non-GAR policyholders. The financial regulator also failed to identify the problem.

I now turn to the Compromise Scheme Proposal (CSP). In considering how to vote, policyholders need to ask the following questions:

21. Is the information provided the most up-to-date available? Most of the information in the above documents is now nearly six months old. In the interests of transparency and full disclosure, the following additional information is needed: a statement of affairs at November 30 providing information on:
    - Number of policyholders (both GAR and non-GAR) still in the fund
    - Value of the fund
    - Solvency level of the fund
    - Fund available for appropriations.
22. What is the future for the fund after the vote? The CSP does not provide policyholders with answers to the following questions:
    - Is the fund to be absorbed by Halifax into its own with-profit fund and will it therefore be part of an ongoing fund into the future?

- Will the fund remain closed with Halifax's role merely to manage the run-off?
- Will the fund remain a mutual fund or is there a deal with the Halifax to demutualise?
- How will the fund be run in future? Will it remain a with-profit fund or should it be treated as a managed fund?
- If the CSP is not approved, will the Halifax simply walk away and what will happen to the Halifax £250mn most of which is already on loan to ELAS in any case?

23. Is the Compromise Scheme Proposal fair and reasonable? I conclude that the CSP might well be 'fair and reasonable' in an actuarial sense, but that policyholders have not been given sufficient information to determine whether it is 'fair and reasonable' in the financial economics sense that I have outline above, namely whether one group of policyholders (the GARs) are being adequately compensated for the guarantees given up and whether the other group of policyholders (the non-GARs) are being adequately compensated for being providers of insurance to the first group.
24. Is the Compromise Scheme Proposal the best that can be done? I conclude that policyholders have not been provided with adequate information to assess whether the CSP is in the best interests of both GAR and non-GAR policyholders. In particular, proposals involving splitting the fund between GAR and non-GAR policyholders have not been adequately considered and have not been tested in court.
25. Will a vote in favour of the Compromise Scheme Proposal put an end to further claims against the Society? I conclude that the information provided by the Board on the likelihood of a claim against ELAS as well as the likelihood of it succeeding is inadequate in the following respects:
    - The Board has provided no direct information on the number of policyholders who have left since 8 December 2000 and who may be in a position to claim damages
    - In *Proposed Compromise: Ready for Your Comments* (p9) it is claimed that ELAS's legal advisers have assessed the probability of the success of any claim at between 20% and 70%. Estimates of probabilities of success are notoriously unreliable unless they are based on relevant recent experience and there is no obvious recent case upon which to base the chances of success. There is insufficient information on how these probabilities have been determined and the confidence with which they are held.
    - Reserves of £50mn have been put aside to cover the costs of any potential claim. What happens if this level of reserves is inadequate?
26. It might be the case that even if policyholders had answers to these questions it would still be in their best interests to vote YES, since the level of uncertainty might well be lowered. And policyholders should not forget that they are currently part of a dead fund which is likely to remain a dead fund if they vote NO. At least there is some chance that if they vote YES, they will become part of a living fund again.

27. Finally as a public policy recommendation, I would propose that, in future, investors should only be permitted to participate in the same pooled investment fund if they all get the same expected (or *ex ante*) return. There will be circumstances where investors will get different realised (or *ex post*) returns on their investments in the same pooled fund. For example, annuitants within the same mortality pool will get different realised returns, since some will die earlier than others, but they still have the same expected returns at the time that the annuity is purchased. In the case of the ELAS with-profit fund, the expected returns of the GAR and non-GAR policyholders were very different after 1988 and this situation should not be permitted in future.

1. A Financial Economics Interpretation of the Events leading up to the Compromise Scheme Proposal

1.1 There have been a number of **legal** and **actuarial** interpretations of the events leading up to the CSP (see Appendix A). I will now present an interpretation from a **financial economics** perspective.

1.2 Between 1957 and 1988, the Equitable Life Assurance Society (ELAS) offered guaranteed annuity rates (GARs) to its with-profit policyholders (these GARs applied to single-life fixed annuities only). Those policyholders who accepted the guarantees did not pay extra for them. For the whole period between 1957 and 1988, the guarantees had no *intrinsic value*, since the GARs were much lower than current market annuity rates (CARs); it was only after 1993 that the GARs began to have an intrinsic value as CARs fell below GARs. However, the GARs also had a *time value* which ELAS failed to price.

1.3 In addition, the GARs were subject to interest rate and mortality risks which ELAS did not explicitly hedge, but which it believed it could manage by 'discretion'. In contrast, other life offices chose to reinsure these risks or, alternatively and before the situation became too serious, bought out GAR rights or capped them and used an orphan fund to run them off.

1.4 The discretion took the form of a differential final bonus policy, whereby those GAR policyholders who opted to take GAR pensions when they retired were offered a lower final bonus than those GAR policyholders who elected to take their benefits in a different form, such as a joint-life annuity. ELAS believed its discretion was lawful under Article 65 of its Memorandum and Articles of Association. Some policyholders complained that the differential final bonus policy nullified the effect of the guarantees. A House of Lords ruling on 20 July 2000 accepted this argument and obliged ELAS to honour those guarantees which were valued at the time at £1.5bn. However, since ELAS is a mutual organisation without shareholders, the Board of ELAS argues that the only source of funds available to honour the guarantees is the general with-profit fund which includes non-GAR policyholders.

1.5 In consequence, the non-GAR with-profit policyholders have been gravely misled by their participation in the ELAS with-profit fund, especially those who joined after January 1994. **The main principle underlying the House of Lords ruling was equal treatment, but equal treatment could never be achieved while both GAR policyholders and non-GAR policyholders were members of the same with-profit fund.** Other life offices separated the funds of GAR and non-GAR policyholders.

1.6 **The reason for this is that a guaranteed annuity is a 'fixed' rather than a 'with-profit' product and it is therefore highly inappropriate from a risk management perspective to offer products with guarantees within a with-profit fund. The purpose of a with-profit fund is for the claims against the fund to be flexible and to rise or fall in line with the underlying assets in the fund, but in a less volatile fashion. Guaranteed annuities, on the other hand, are options that when exercised become fixed claims on the fund.**

1.7 **A guaranteed annuity can be interpreted in financial engineering terms as an *interest rate put option* on a stream of payments**. The holder of the option has the right to a stream of payments (the pension annuity) calculated with reference to a guaranteed interest rate (in financial engineering terms, the *exercise price* of the put option). This option has no *intrinsic value* (and is said to be *out-of-the-money*) if the market interest rate is above the guaranteed rate, although it will still have a *time value* since there is always a possibility that the market interest rate will fall below the guaranteed rate at some future date. The option begins to have an intrinsic value (and becomes *in-the-money*) as well as a having time value when this happens.

1.8 The option expires on the date the GAR policyholder retires and the time value falls to zero. But if the market interest rate is below the guaranteed rate at this time, the option will still have an intrinsic value which will be higher the lower the market rate is relative to the guaranteed rate. It is therefore likely that the option will be *exercised* by the GAR policyholder in order to extract the intrinsic value and this is achieved by the policyholder electing to take the annuity at the guaranteed rate, rather than one at the lower market rate. It is the combination of the time value and potential intrinsic value embedded in the guaranteed annuity over the long period of participation in the with-profit fund that makes it such a valuable product and explains why the Board, prior to the House of Lords ruling, awarded a higher final bonus to those GAR policyholders who elected not to take GAR benefits when they retired[2].

1.9 However, **the fact that some members of the same with-profit fund had a GAR while others did not violates a key principle underlying a pooled fund, namely that all members expect to be allocated the same rate of return**. It also violates the House of Lords ruling that all members should receive the same bonus. On 16 July 2001, the Board reduced **all** policy values by 16%, but the

[2] The option is actually more complicated than described for two reasons. There are a range of possible expiry dates for the option since policyholders have flexible retirement possibilities, so the option is *American-style* rather than *European-style*. Also the option has two exercise prices, one being the guaranteed interest rate and the other being the assumed mortality rate, so the option is a *multiple-factor exotic* option rather than a *standard* option. Such options are hard to price but are very valuable given their long time to expiry.

Compromise Scheme Proposal (CSP) uplifts the GAR policy values by 17.5% (on average), while non-GAR policy values are uplifted by only 2.5%.

1.10 The explanation for these different uplifts is very simple**: since ELAS did not hedge its insurance risk exposure to the GAR policyholders, it, by default, transferred the burden of providing this insurance to the non-GAR policyholders.** In short, **the non-GAR policyholders became unwitting providers of insurance to the GAR policyholders**. In financial engineering terms, **ELAS caused non-GAR policyholders (without their knowledge or approval) to write interest rate put options which are held by GAR policyholders.** If someone has been given the right to take a fixed amount from a single fund, then, by default, those without that right have accepted an obligation to give this fixed amount whatever the size of the fund.

1.11 In general, it is a breach of the Financial Services Act 1986 for anyone to advise an investor to take positions in derivative instruments, such as options, without being registered to do so and without explicitly advising the investor in writing about the risks involved and for the investor to acknowledge in writing that he/she understand these risks. However, I am not qualified to say whether the Financial Services Act applies to the type of options involved here.

1.12 These interest rate put options began to have intrinsic value (as well as time value) when market interest rates fell below the guaranteed rates from late 1993. **The non-GAR policyholders received no premium for issuing these options, thereby violating the first principle of sound insurance, namely that the insurance provider collects sufficient premiums to pay for any likely claims.** Although the options were issued free of charge, the claims by the GAR policyholders against the non-GAR policyholders are being funded by the 15 percentage point difference between the uplifts of the GAR and non-GAR policies proposed in the CSP. **In a competitive insurance market, insurance providers expect to break even, so it is arguable that the value of the premiums 'owed' by the GAR policyholders to the non-GAR policyholders for providing the insurance is also equal to the difference between the uplifts, namely 15 percentage points.**

1.13 Since it is most unlikely that the non-GAR policyholders would be willing to provide insurance to the GAR policyholders free of charge (although the vote on 11 January 2002 is inviting them to do so), **the non-GAR policyholders have a very strong case for arguing that their funds should have been separated from the very start from the funds of the GAR policyholders**, although the House of Lords ruled that GAR policyholders' funds could not be ring-fenced from those of non-GAR policyholders.

1.14 There are two critical dates prior to the House of Lords ruling: July 1988, when ELAS stopped selling GAR policies, and late 1993, when the problem with market interest rates falling below guaranteed rates first surfaced.

1.15 Policyholders who joined after July 1988 were not able to choose a GAR, yet their funds were still pooled with existing GAR policyholders' funds. The Board at the time must have considered the **possibility** that the non-GAR policyholders would be called upon to cross-subsidise the GAR policyholders via the allocation of lower bonuses (in financial engineering terms have their put options exercised against them) at some point in the future; otherwise why did the Board cease offering GARs after 1988 if they were such innocuous products that it did not matter whether policyholders belonging to the same fund had them or not?

1.16 In the case of policyholders who joined after January 1994, the Board at the time must have considered it **highly probable** that the non-GAR policyholders would have their put options exercised against them at some point in the future, yet they still allowed the contributions of those who joined after January 1994 to be added to the same fund as the GAR policyholders. **In financial engineering terms, after January 1994 non-GAR policyholders were being induced to write in-the-money put options that were highly likely to be exercised, but were receiving no premiums for doing so.**

1.17 After 20 July 2000 it became **certain** that the non-GAR policyholders would have to cross-subsidise the GAR policyholders in a substantial way. **The House of Lords ruling on 20 July 2000 (on ring fencing) recognised formally the position that the non-GAR policyholders had been placed in as unwitting providers of insurance to the GAR policyholders. Yet the Board continued to accept new non-GAR policyholders into the single with-profit fund even after the House of Lords ruling.**

1.18 In *Proposed Compromise: Ready for Your Comments* (p2), the present Board states that ELAS's difficulties stem from the House of Lords ruling that the differential bonus policy was illegal. From the perspective of financial economics, however, **the present Board's difficulties stem from the fact that previous Boards issued guarantees that were not adequately priced and the risks associated with them were not adequately managed.** The House of Lords ruling forced ELAS to recognise the underlying problem, but did not cause it. This point is acknowledged in the Appointed Actuary's Report of 22 November 2001 (p2): 'statutory reserve was less affected by the House of Lords' Judgment than was the realistic liability; nevertheless, it was higher than had been set up in previous years owing to the use of more prudent assumptions, and to falling interest rates that made the GARs more valuable'.

1.19 The Board accepts that the GAR and non-GAR policyholders have 'different interests' (*Background to the Proposed Compromise the Board* p32). But **the difference in interests extends beyond that between an insurance provider and an insurance taker, it is also reflected in different appropriate investment policies for the with-profit fund.**

1.20 The non-GAR policyholders are primarily interested in equity performance with some smoothing of returns. They could have picked a unit-linked fund which also benefits from equity performance but has no smoothing of returns and chose not to do so. They could have picked a bond-based fund which has low volatility in asset values, but also lower long-term returns, and chose not to do that either. Instead, they chose a with-profit fund which has both equity performance and smoothing, i.e., they valued high but smoothed long-term returns

1.21 The GAR policyholders, on the other hand, valued guaranteed returns on annuities. Now annuities are essentially bond-type products not equity products and the natural assets for matching these liabilities are bonds which have lower long-term but more stable returns than equities. **This has strong implications for the asset allocation of the with-profit fund that is most appropriate for meeting the needs of GAR policyholders: the fund should have been heavily invested in bonds, rather than equities from the very beginning. However, this asset allocation is incompatible with the interests of the non-GAR policyholders who wish to have a high equity weighting for the fund.**

1.22 However, the Board at the time chose not to hedge its exposure to GARs, instead relying on the high equity weighting in the fund to deliver such high returns that the GAR liabilities could be met without explicit hedging of the exposure to them. **Leaving liabilities unhedged is potentially very risky and violates the second principle of sound insurance, namely that assets should be selected to match liabilities as closely as possible**.

1.23 So the Board had to do something else as well: **it had to attract sufficient new non-GAR policyholders to help it bail out the GAR policyholders if equity performance was inadequate.** So after 1988 when GARs ceased to be offered, **the ELAS with-profit scheme began to take on the characteristics of a Ponzi[3] scheme**. **Ponzi schemes have the following characteristics:**

- **the high returns achieved by the initial members of such scheme are paid in part out of the contributions of the later joiners**

[3] Charles Ponzi made a quick fortune in the 1920s in the US using chain letters. However, he was sent to prison and died in poverty. Pyramid selling or a pyramid savings schemes are examples of Ponzi schemes.

- **they require an increasingly rapid inflow of new members to sustain themselves**
- **they end abruptly when the inflow of new members ceases**
- **those who join very late in the scheme's life lose a lot of money.**

These are all characteristics shared by the ELAS with-profit scheme. The scheme might not have started as a Ponzi scheme but it is arguable that is how it ended up. An apparently innocuous offer of a guaranteed annuity in 1957 can start a process that builds up into catastrophe 40 years later.

The Growth of ELAS 1990-2000

	New annual premiums (£m)	Single premiums (£m)	Premium income (£m)	Investment income (£m)	Net total assets (including unit linked) (£m)
1990	258	578	1346	376	5786
1991	281	835	1715	459	7368
1992	294	932	1877	572	9497
1993	323	1087	2101	668	13407
1994	309	1035	2052	741	13545
1995	326	1290	2362	842	16612
1996	415	1590	2830	997	19305
1997	494	1950	3452	1071	23676
1998	419	2177	3730	1121	28068
1999	342	1978	3484	1198	32902
2000	280	1515	2941	1256	34754

Source: ELAS Annual Reports 1999 and 2000.

1.24 The Board of ELAS was successful in attracting new members to the with-profit fund (see table above). By 30 June 2001, 75% by value of the with-profit fund was accounted for by non-GAR policyholders. In addition, the with-profit fund is solvent, so long as the non-GAR policyholders agree to meet the insurance claims of the GAR policyholders (i.e., give permission for the interest rate put options to be exercised against them) as the CSP invites them to do on 11 January 2002. In *Proposed Compromise: Ready for Your Comments* (p3), the Board claims that there is little point in the non-GAR policyholders suing since 'they would in effect be largely suing themselves because they constitute three-quarters of the Society's with-profits fund'. **This statement also demonstrates the critical significance of the non-GAR policyholders in the Ponzi scheme's endgame: GARs could never be delivered within a with-profit fund unless a substantial proportion of policyholders were not entitled to receive them; without the non-GAR policy holders providing a buffer, the GARs would have to be lowered if the funds were inadequate.**

1.25 However, the with-profit fund closed to new business on 8 December 2000, so the inflow of new non-GAR members ceased. In addition non-GAR policyholders have been transferring their funds out of the scheme, thereby reducing the base for meeting the claims of the GARs. The effect of the House

of Lords ruling, coupled with the failure to sell ELAS, was to put an end to new members joining. More significantly, **the effect of the House of Lords ruling was to legitimise this Ponzi scheme, since their Lordships ruled that the funds of the non-GAR policyholders could not be separated from those of the GAR policyholders**. Furthermore, Nicholas Warren QC and Thomas Lowe argue that there are no legal grounds for challenging the House of Lords ruling.

1.26 The closure of the fund to new entrants has had a dramatic effect on the asset allocation of the fund. The Board had no alternative but to lower the weighting in equities and increase the weighting in bonds in order to match the GAR liabilities. At 30 June 2001, the equity weighting was 48%. By 31 October 2001, the weighting had fallen to 34%. So **the non-GAR policyholders, despite selecting a with-profit equity-dominated fund, have ended up with a bond-dominated fund with little upside potential in terms of future bonus additions.**

1.27 Furthermore, **the closure of the fund to new members has turned the scheme from an ongoing scheme into a run-off scheme**. **Without a regular inflow of new and younger members, who bring the joint benefits of immediate contributions but distant maturing liabilities, the investments will have to be managed principally for the purpose of delivering pension payments rather than for generating growth. This massively reduces future investment flexibility. This lack of flexibility is reinforced by the present low level of free assets.**

1.28 **The combined effect of all these factors was to turn the fund from a with-profit fund heavily invested in equities, but with smoothing possibilities, into a managed fund, but with little realistic hope of benefiting from the upside potential that equities offer in the long term.** The investments must be held mainly in fixed-income bonds in order to generate regular cash flows to pay pensions. Although some equity could be held, policy values would fall if the equity markets fell, but are unlikely to rise in line with any rise in equity markets in order to build up reserves.

1.29 **The non-GAR policyholders have therefore suffered a triple whammy:**

- **An insurance claim against them from the GAR policyholders in return for which they have received no insurance premiums**
- **An investment fund, dominated as it is by bonds, which looks very unlike the with-profit equity-dominated fund they believed they were buying into, and**
- **An end to the possibility of new members joining to help spread the burden that they face.**

1.30 **On the basis of this financial economics interpretation of the events leading up to the CSP, the key decisions made by the previous Boards of ELAS are these:**

- **They offered a non-with-profit product within a with-profit fund**
- **They accepted a risk exposure by offering GARs that they neither priced nor hedged adequately**
- **They subsequently tried to nullify the effect of their commitment to GAR policyholders via a differential final bonus policy**
- **When this failed, as a result of the House of Lords ruling, they transferred (even if by this stage they had little choice) the commitment to honour the guarantees to non-GAR policyholders**
- **They chose an asset allocation for the with-profit fund that is suitable neither for delivering the GAR product nor for meeting the interests of the non-GAR policyholders**
- **They closed the fund to new members.**

In financial economics terms (if not in legal term), these constitute substantial breaches of the agreements both implicit and explicit that the previous Boards had with both their GAR and non-GAR policyholders. The financial regulator also failed to identify the problem.

2. The Adequacy and Objectivity of the Information Provided by the Board in Connection with the Compromise Scheme Proposal

2.1 I have been asked to assess whether the information provided by the Board concerning the Compromise Scheme Proposal is adequate and objective.

2.2 I have based this assessment on the following documents:

- *Proposed Compromise: Ready for Your Comments* – 28 pages
- *Background to the Proposed Compromise* – 46 pages
- *Scheme Circular* – 191 pages
- *Your Questions Answered* – 18 pages
- *Interim Report for the Half Year Ended 30 June 2001*– 22 pages.

2.3 Based on my understanding of the Compromise Scheme Proposal and the events leading up to it, I consider the following list of questions to be the most important ones that ELAS policyholders need to ask themselves before deciding how to vote. They need to consider whether they have been provided with adequate and objective information in the above documents in order to answer them.

2.1 Is the information provided the most up-to-date available?

2.4 Most of the information in the above documents is now nearly six months old.

2.5 **In the interests of transparency and full disclosure, the following additional information is needed: a statement of affairs at November 30 providing information on:**

- **Number of policyholders (both GAR and non-GAR) still in the fund**
- **Value of the fund**
- **Solvency level of the fund**
- **Fund available for appropriations.**

2.2 What is the future for the fund after the vote?

2.6 The *Scheme Circular* is quite clear in spelling out that the uncertainties in the with-profit fund will remain and that future bonuses will remain low if there is a NO vote (*Scheme Circular* p104). There is also a great deal of pessimism expressed about the alternatives to the CSP (*Background to the Proposed Compromise the Board* p30-37).

2.7 However, the *Scheme Circular* is very unclear on what the with-profit fund's future will be if there is a YES vote. In particular, it is not clear from the *Scheme Circular* what the precise role of Halifax will be in the fund's future if the CSP is approved or if the CSP is not approved.

2.8 **The CSP does not provide policyholders with answers to the following questions:**

- **Is the fund to be absorbed by Halifax into its own with-profit fund and will it therefore be part of an ongoing fund into the future?**
- **Will the fund remain closed with Halifax's role merely to manage the run-off?**
- **Will the fund remain a mutual fund or is there a deal with the Halifax to demutualise?**
- **How will the fund be run in future? Will it remain a with-profit fund or should it be treated as a managed fund?**
- **If the CSP is not approved, will the Halifax simply walk away and what will happen to the Halifax £250mn most of which is already on loan to ELAS in any case?**

2.3 Is the Compromise Scheme Proposal fair and reasonable?

2.9 On 16 July 2001, the Board reduced all policy values by 16% of their 31 December 2000 level. The CSP calculates the actuarial value of the claims of policyholders to be equivalent to uplifts in policy values of 17.5% (on average) for GAR policyholders and 2.5% for non-GAR policyholders.

2.10 I am not qualified to assess whether these uplifts are 'fair and reasonable' in an actuarial sense, but I can say that the CSP is not 'fair and reasonable' in terms of the financial economics interpretation given above:

- The CSP claims that the GAR policyholders are being 'compensated' for giving up their GAR rights. But the CSP does not provide a clear statement of what the GAR policyholders are foregoing by accepting the CSP, namely a 20% lower pension in relation to current annuity rates.
- The CSP also claims that the non-GAR policyholders are being 'compensated' for giving up their claims for compensation against ELAS for potential misselling. But the CSP does not provide a clear statement admitting that the 2.5% uplift for non-GARs includes their premium for providing interest rate and mortality insurance to GAR policyholders in addition to their compensation for giving up their potential misselling claims.

2.11 **I conclude that the CSP might well be 'fair and reasonable' in an actuarial sense, but that policyholders have not been given sufficient information to determine whether it is 'fair and reasonable' in the financial economics sense that I have outline above, namely whether one group of policyholders (the GARs) are being adequately compensated for the guarantees given**

up and whether the other group of policyholders (the non-GARs) are being adequately compensated for being providers of insurance to the first group (in addition to compensation for giving up potential misselling claims).

2.4 Is the Compromise Scheme Proposal the best that can be done?

2.12 The CSP is not the only possible solution to ELAS's present predicament. Another solution would recognise the fundamental difference of interests between the GAR and non-GAR policyholders.

2.13 Neither GAR nor non-GAR policyholders may be fully aware of the nature of each other's different interests in the with-profit fund, since the CSP does not fully explain them. Nevertheless, the present Board cites these differences of interest as one of the reasons for believing why Option 2 on bilateral agreements would not work (*Background to the Proposed Compromise* p32): 'it is almost certain that an Extraordinary General Meeting of members would have to approve the Society's offer and methodology but under the Society's present constitution, this could be attended by both GAR and non-GAR policyholders who would have different interests and thus a structure would need to be developed to enable the GAR and non-GAR policyholders to vote on the offer in isolation'. The fact that GAR and non-GAR policyholders also have different votes concerning the future of the same mutual fund also recognises their difference of interests.

2.14 The following proposal would have recognised the difference in interests between the two classes of policyholder:

- Policy values would have been reduced immediately after the House of Lords ruling in order to penalise exercise of the GAR option and transfers from the fund at above fair value
- The with-profit fund would have been transferred to special purpose vehicle with the GAR policies amended to reflect notional asset share under Schedule 2C Insurance Companies Act 1982 or Section 112 Financial Services and Markets Act 2000
- The with-profit fund would then be separated into two funds, a GAR fund and a non-GAR fund (the Board has the power to create sub-funds (Independent Actuary's Report p5))
- If appropriate a claim for damages against relevant third parties would be instigated

2.15 The proposal would be tested in court to see whether this met with the House of Lords ruling on equal treatment, although policyholders have been warned by Warren and Lowe that it might not. The Board claim that they have been advised that there is 'no absolute certainty' that the court would approve the amendments made under the Insurance Companies Act or Financial Services and Markets

Act. However, this statement is meaningless, since nothing pertaining to the future is 'absolutely certain' except, of course, death and taxes.

2.16 This proposal is certainly feasible, since the Appointed Actuary believes (Report, 22 November 2001, p12) that ELAS's existing 'exposure to GAR liabilities could be managed although adjustment would be required to cover changing patterns of retirement. The risk associated with declining interest rates would be substantially covered because fixed-interest holdings would rise in value to help compensate for increasing GAR costs but any change in take-up rates which might accompany falling interest rates as the GAR becomes more valuable would be difficult to match. It is therefore not feasible to match this risk exactly and the ongoing uncertainty would be difficult even if manageable'.

2.17 The difference between this solution and the CSP is that the economic transfer from non-GAR to GAR policyholders would not have taken place and the GAR policyholders would find themselves confronted with their true position, namely that they have a very valuable claim (although they paid no premium for it) but there are insufficient resources to meet it. That is not their fault, of course, it is the fault of the previous Boards of ELAS for massively underpricing its products, then for not choosing an investment strategy that matched the liabilities created by selling those products and lastly for trying to get new non-GAR customers to help bail them out. The ELAS GAR policyholders would be in no different position from the GAR policyholders of other life offices whose GAR claims were bought out at low cost in the early 1990s.

2.18 **I conclude that policyholders have not been provided with adequate information to assess whether the CSP is in the best interests of both GAR and non-GAR policyholders. In particular, proposals involving splitting the fund between GAR and non-GAR policyholders have not been adequately considered and have not been tested in court.**

2.5 Will a vote in favour of the Compromise Scheme Proposal put an end to further claims against the Society?

2.19 The CSP does not provide full stability. It only prevents UK residents who are policyholders on the implementation date from suing the Society. 'The Scheme will not necessarily prevent other policyholders from bringing claims against the Society outside the UK and/or seeking to attach the Society's assets held overseas' (*Scheme Circular*, Para 5.9.3, p38).

2.20 Paragraph 5.9.4 of the *Scheme Circular* (p38) sets out the possible extent of claims by past non-GAR policyholders. Between August 2000 and July 2001, non-GAR holders representing £2.3bn left

the fund. In addition in August and September 2001 holders of a further £1.45bn had left or applied to leave. Therefore holders of at least £3.75 billion of funds will have left ELAS before the vote and can sue. Claims in relation to such funds would not be compromised by the CSP.

2.21 Such members could have claims equivalent to the bonuses they have lost (para 4.8 of the *Scheme Circular*). In addition those who have left could have claims equivalent to the CSP uplift of 2.5% (para 4.8). In addition ELAS could spend up to £500 per claim in defending against their claims.

2.22 As the end of Para 5.9.4 of the *Scheme Circular* clearly states: 'It is important for Scheme Policyholders to appreciate that, for the above reasons, a successful Scheme will not necessarily mean an end to all GAR-related litigation against or involving the Society'.

2.23 In *Background to the Proposed Compromise* (p21), the Board emphasises the uncertain prospects of any claim by the non-GARs. However, if the funds are split, the claim in *Proposed Compromise: Ready for Your Comments* (p3) that there is little point in the non-GAR policyholders suing since 'they would in effect be largely suing themselves because they constitute three-quarters of the Society's with-profits fund' would be invalid.

2.24 Nevertheless, some might argue that natural justice dictates that both sides have their case heard. The case of the non-GAR policyholders has not been heard. The non-GAR policyholders might have a strong case for a judicial review of the CSP.

2.25 **I conclude that the information provided by the Board on the likelihood of a claim against ELAS as well as the likelihood of it succeeding is inadequate in the following respects:**

- **The Board has provided no direct information on the number of policyholders who have left since 8 December 2000 and who may be in a position to claim damages**
- **In *Proposed Compromise: Ready for Your Comments* (p9) it is claimed that ELAS's legal advisers have assessed the probability of the success of any claim at between 20% and 70%. Estimates of probabilities of success are notoriously unreliable unless they are based on relevant recent experience and there is no obvious recent case upon which to base the chances of success. There is insufficient information on how these probabilities have been determined and the confidence with which they are held.**
- **Reserves of £50mn have been put aside to cover the costs of any potential claim. What happens if this level of reserves is inadequate?**

3. Conclusion

3.1 The Compromise Scheme Proposal seeks to compensate both GAR and non-GAR policyholders for the value of their 'rights' given up. The Appointed Actuary's Report (22 November 2001, p8) argues that 'the method of quantifying the potential non-GAR claims has also been underpinned by the need for fairness'. Yet from a financial economics perspective, the CSP amounts to the formal closure of a Ponzi or pyramid savings scheme, whereby those who joined the scheme late supported the returns of those who joined early by providing them with insurance against interest rate and mortality risk. This closure will be achieved through the exercise of the interest rate put options by the GAR policyholders and the transfer of the intrinsic value of these options, valued at 15% of the non-GAR policyholders fund values or £630mn, from the non-GAR to the GAR policyholders. Yet even with this transfer, GAR policyholders retiring today would be getting 20% less than their guarantees warrant.

3.2 Interest rate risk and mortality risk are the core risks facing any life office and policyholders are entitled to expect their life office to be able to manage them. However, the Equitable Life Assurance Society did not have an effective legal mechanism in place to manage these risks and, as a consequence of this and its mutual structure, the cost of this failure has been transferred to its members, in particular the non-GAR policyholders who have joined the with-profit fund most recently. The financial regulator (the Financial Services Authority and its predecessors) also failed to identify the problem sufficiently early on.

3.3 From a financial economics perspective, non-GAR policyholders have a case for having their funds split from those of the GAR policyholders and this case has increasing strength for those joining between July 1988 and the end of 1993, those joining between January 1994 and 20 July 2000 and those joining between 20 July 2000 and 8 December 2000.

3.4 However, between them the present and previous Board have probably and very skilfully engineered a *fait accompli* in respect of the CSP. They:

- Closed the with-profit fund and sold off the infrastructure, and so turned it from an ongoing fund into a run-off fund with little chance of opening up again as an independent organisation (this was done without the approval of members)
- Lowered policy values by strictly more than was necessary to reserve for the full GAR claim and promises to pay out no more than is contractually required while the GAR uncertainty remains

- Provided a small sweetener in term of the Halifax money if there is a YES vote before 1 March 2002
- Conducted a 'doom and gloom' media campaign that warns of the dangers and costs of voting against the CSP. For example, the headline in the *Financial Times* (p4) on 7 December 2001, the day after the CSP was released went: 'Equitable presents policy shareholders with final deal: Compromise offer "is mutual's last chance"'

3.5 Policyholders find themselves squeezed between two dates: 8 December 2000, the date the scheme closed, and 1 March 2002 when the Halifax money runs out. The £250mn Halifax money on a fund valued at £20bn is equivalent to less than three months' interest at the rate of 5.5% assumed by the Appointed Actuary to value the GAR liabilities (equivalent to about £300 per policy), so the Halifax money ought not to be a serious consideration when members decide to vote.

3.6 Sensible decisions can only be made on the basis of transparency and full disclosure. The information provided by the Board is inadequate in the following respects:

- Most of the information concerning the status of the fund is out of date
- There is virtually no information on what is going to happen to the fund after the vote
- What both GAR and non-GAR policyholders are foregoing by voting for the CSP are not clearly spelled out
- Alternatives to the CSP that would be fairer to non-GAR policyholders, such as splitting the fund into GAR and non-GAR funds have not been adequately considered
- A YES vote will not necessarily put an end to further claims against ELAS and an assessment of the likelihood of this happening is not provided.

3.7 It might be the case that even if policyholders had answers to these questions it would still be in their best interests to vote YES, since the level of uncertainty might well be lowered. And policyholders should not forget that they are currently part of a dead fund which is likely to remain a dead fund if they vote NO. At least there is some chance that if they vote YES they will become part of a living fund again. On the other hand, GAR policyholders have the strongest incentive to vote NO, despite getting the better deal from the CSP: they have the stronger legal claim, they constitute just 25% of the total fund, and by voting NO could end up getting even more. By the same token, non-GAR policyholders might decide to vote YES to reduce the probability of doing even worse if the CSP is rejected. However, they also have a strong incentive to leave and sue for compensation for misselling.

3.8 Finally as a public policy recommendation, I would propose that, in future, investors should only be permitted to participate in the same pooled investment fund if they all get the same **expected** (or *ex ante*) return. There will be circumstances where investors will get different **realised** (or *ex post*) returns on their investments in the same pooled fund. For example, annuitants within the same mortality pool will get different realised returns, since some will die earlier than others, but they still have the same expected returns at the time that the annuity is purchased. In the case of the ELAS with-profit fund, the expected returns of the GAR and non-GAR policyholders were very different after 1988 and this situation should not be permitted in future.

Appendix A: Background to the Compromise Scheme Proposal

A.1 Between 1957 and 1988, the Equitable Life Assurance Society (ELAS) sold with-profit pension annuities with 'guaranteed annuity rates' (GARs) fixed by reference to specific assumptions as to interest rates and life expectancy. The GAR annuities were fixed-rate, single-life annuities. The guaranteed annuity rates were fixed at a level well below the annuity rates available at the time. Since 1988 only non-guaranteed annuity rate (non-GAR) policies have been sold. All premiums arising from both types of policy were invested in ELAS's with-profit fund. Although the sale of policies with a GAR option ended in 1988, many with-profit policies still offered 'guaranteed interest rates' (GIRs), i.e., a guaranteed rate of investment on guaranteed benefits, typically at the rate of 3.5% p.a. for pension policies. Such guarantees were progressively discontinued from 1996 onwards. By mid-2001, 75% of policies by value still had GIRs of 3.5%.

A.2 As of 30 June 2001, there were 70,000 individual with-profit policyholders with GARs (representing 25% of the total value of the with-profit fund) and 415,000 individual with-profit policyholders without GARs (representing 75% of the total value of the with-profit fund). In addition there are 105,000 GAR and 510,000 non-GAR policyholders in group pension schemes.

A.3 In late 1993, open market current annuity rates (CARs) fell below the GAR annuity rates promised by ELAS, thereby raising the cost to ELAS of providing GAR pensions. CARs rose above GARs in 1994, but in 1995 they fell below GARS and have remained below ever since. In addition, the assumptions concerning life expectancy used to determine the size of the GAR pension payments were not revised in the light of improvements in mortality that had taken place since they had been set, further raising the cost of the pensions. The Board at the time did not take these extra costs into account when it awarded annual bonuses and all members' policy values (both GAR and non-GAR) increased at the same rate.

A.4 However, the Board corrected for the extra cost of the GARs through a 'differential final bonus policy' first introduced in 1993 and which it considered was within the discretion it had under Article 65 of the Memorandum and Articles of Association of ELAS. The intention was to declare final bonuses that made the value of total benefits broadly equal to each policyholder's notional share of the with-profits fund (the 'asset share'), i.e., the value of the premiums paid increased with investment return and a fair share of any profits and losses to the fund less expenses (subject to a minimum of the guaranteed benefits, i.e., the 'guaranteed value'). Those policyholders who elected to take the GAR option from ELAS received a lower final bonus than those policyholders who, despite having a GAR option, elected to take their pension benefits in a different form, such as joint-life annuities, but at the

lower market rate ruling at the time. The Board thought that this strategy was legal; the Institute of Actuaries and Treasury Insurance Directorate agreed.

A.5 As a result of complaints from some policyholders who argued that the differential bonus policy rendered the GARs valueless, ELAS initiated a ‘representative action’ in the High Court to resolve the issue (this became known as the Hyman litigation). The case ended up in the House of Lords which ruled on 20 July 2000 that ELAS could not apply a differential bonus policy to any class of policyholder whether GAR or non-GAR. Those GAR policyholders who had exercised their GAR option between January 1994 and 20 July 2000 had to be given the same final bonus as the GAR policyholders who had not taken the GAR option and then the GAR had to be applied to the revised terminal policy value. Crucially the House of Lords also ruled that the cost of meeting the GAR liabilities could not be ‘ring fenced’ within the class of GAR policyholders.

A.6 To illustrate, suppose there are two GAR policyholders each with policy values of £60,000 prior to retirement, asset shares of £100,000 and GARs of 10% when the current annuity rate is 8%. One policyholder decides to take an annuity from a provider other than ELAS and receives a final bonus from ELAS of £40,000. The £100,000 terminal policy value is used to buy an annuity of £8,000 p.a. at the current annuity rate of 8% (for simplicity I assume zero mortality after retirement). The other policyholder chooses to take the GAR annuity from ELAS. ELAS awarded the second policyholder a final bonus of £20,000, implying a terminal policy value of £80,000 and applied the 10% GAR to this, giving an annuity of £8,000 p.a. to this policyholder as well. The cost to ELAS of providing the GAR annuity was £100,000 at the current annuity rate of 8%. So both annuitants received their asset share. However, the House of Lords ruling required both GAR policyholders to have the same terminal policy value of £100,000 and for the 10% GAR to be applied to this value. This resulted in an annuity of £10,000 p.a. and a cost to ELAS of £125,000 at the current annuity rate of 8% (since 8% of £125,000 is £10,000).

A.7 The total cost to ELAS was estimated at the time to be 25% of GAR policy values or £1.5bn, comprising £200mn to cover the lower GAR pension payouts between January 1994 and 20 July 2000 (the ‘rectification scheme’) and £1.3bn for correcting future shortfalls. This sum had to be taken from the single with-profit fund that invested both GAR and non-GAR premiums. As at 20 July 2000, 25% of the with-profit fund represented GAR policyholders’ claims and 75% non-GAR policyholders’ claims. So the House of Lords ruling meant that an ‘economic transfer’ of claims of £1.1bn (75% of £1.5bn) from non-GAR to GAR policyholders had to be implemented.

A.8 In order to both cover and secure the GAR liability and to meet ELAS's statutory capital requirements (the required minimum margin under Section 32 of the 1982 Insurance Companies Act), the Board undertook the following actions. It:

- Set up statutory reserves in respect of the GAR liabilities: these amounted to £1.8bn (net of a reassurance agreement) at 31 December 2000
- Lowered the 2000 final rate to 3.3% after the retrospective reclaiming of 7 months' bonus
- Retrospectively imposed zero growth for the period 1 January 2000 to 31 July 2001
- Used 'financial market value adjustments' of between 7.5% and 12% to reduce non-contractual payouts on surrendered policies, and
- Switched part of the with-profit fund from equities to bonds.

A.9 During the Autumn of 2000, the Board of ELAS offered to sell ELAS as a going concern to an alternative provider, but could find no organisation willing to inject the necessary capital. On 8 December 2000, ELAS was closed to new business. On 20 December 2000, the Board offered their resignation.

A.10 On 5 February 2001, most of the non-with-profit business of ELAS, along with its infrastructure assets and workforce, was transferred to Halifax plc for £500mn. Other assets were also sold to Liverpool Victoria for £150mn. If, in addition, ELAS is able to resolve the problems in the with-profit fund before 1 March 2002 by means of a 'scheme of arrangement' that caps the GAR liabilities in a way that is fair and reasonable between the various classes of policyholders and preserves the solvency of the with-profit fund, then Halifax will pay a further £250mn (the 'Halifax money') and pay an additional sum up to £250mn if, by 2005, certain business sales and profitability targets are met on the business acquired from ELAS (e.g. sales of Halifax-Equitable policies to the old ELAS client database). There is also a 10-year agreement in place whereby Halifax manages ELAS 'at cost'.

A.11 On 16 July 2001, the Board reduced all policy values by 16% of their 31 December 2000 level. The explanation given was that:

- Asset values in the fund had fallen as a result of falling stock markets since the beginning of 2001 and therefore there was a need to bring policy values into line with asset values
- Many policyholders had taken advantage of the flexible policy terms to retire early with proceeds in excess of asset shares.

The financial market value adjustment was set at 7.5%.

A.12 The Board considered two possibilities for compromising the GAR liabilities:

- A 'ring-fenced fund scheme', separate from the with-profit fund, which tops up the asset share of the GAR policyholder on retirement so that any annuity purchased reflects the GAR, with the GAR policyholder having no additional claim on the general with-profit fund.
- A 'GAR buy-out scheme', whereby GAR rights are bought out by means of an immediate uplift in policy values.

A.13 The Board rejected the idea of a ring-fenced fund scheme on the grounds that:

- It contravened the spirit of the House of Lords ruling
- It did not place a cap on future costs.

A.14 The Board felt that a GAR buy-out scheme had a number of advantages:

- The capping and crystallising mechanism fixes the cost of GAR benefits
- All with-profit policyholders are treated on the same basis in future
- GAR policyholders who still wished to take their GAR rights and were contractually able to do so (e.g., were over 60) could do so before the scheme came into effect.

A.15 The Compromise Scheme Proposal (CSP) announced on 6 December 2001 is based on a GAR buy-out scheme. The compromise scheme, if it is accepted by a majority of those voting (and by 75% by value of those voting) amongst both GAR and non-GAR policyholders, will be implemented via a scheme of arrangement under Section 425 of the Companies Act 1985.

A.16 The CSP contains an additional proposal, arising from a legal opinion given by Nicholas Warren QC and Thomas Lowe. Warren and Lowe were asked by ELAS whether the House of Lords ruling on ring fencing could be challenged. They advised that this was not possible[4]. However, they also argued that it was possible that the non-GAR policyholders might have potential claims against ELAS for the potential damage caused by not being informed of the existence and potential impact of GAR rights in policies previously issued by ELAS[5]. The additional proposal in the CSP is that, if it is approved, any

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[4] The House of Lords ruling would appear to be internally inconsistent. On the one hand, it requires all policyholders to receive the same bonus, but the ruling does not permit the separation of the GAR and non-GAR funds, thereby making it impossible to award GAR and non-GAR policyholders the same bonus. On the other hand, if the reason the GAR and non-GAR bonuses are different is because the GAR and non-GAR policyholders are different classes of investor, then their assets should be in separate funds, thereby violating the House of Lords ruling that the funds of the GAR policyholders cannot be ring-fenced from those of the non-GAR policyholders.

[5] Legal opinion differed on this question. The Board sought the views of other Counsel, Gabriel Moss QC, David Richards QC, Martin Moore and Barry Isaacs, who did not agree that non-GAR policyholders could recover this type of consequential loss. Further, Ian Glick QC and Richard Snowden, instructed by the Financial Services Authority, were of the opinion that ELAS should only be liable to the extent to which losses of a non-GAR policyholder are attributable to the undisclosed features of the non-GAR policy, namely the GAR risk.

future right to claim damages against ELAS will be waived by both GAR and non-GAR policyholders.

A.17 The Board argued that four principles underpinned its proposed solution. The solution must:

- Be fair to all with-profit policyholder groups
- Be easily understood
- Mean that all policyholders share the pain and benefit of the compromise
- Be able to be implemented.

In addition the proposal must be acceptable to the High Court.

A.18 The Board claims that the CSP satisfies these principles in respect of GAR policyholders since:

- It involves fair value compensation to the GAR policyholders based on a 'realistic estimate' of the value of their legal rights given up that is neither too optimistic nor too cautious
- It apportions the compensation to different GAR policyholders in accordance with their rights
- It reduces that compensation by the value of any possible claim for compensation given up by the non-GAR policyholders
- The compensation takes the form of a proportionate increase in GAR policyholders' policy values in both guaranteed and non-guaranteed form.

A.19 The Board has valued the GAR rights on the basis of the following factors:

- The level of current and future interest rates
- The proportion of benefits taken in GAR form (e.g., exercising the cash lump sum reduces the value of GAR rights)
- The level of future contributions attracting GAR rights
- Future mortality on a unisex basis
- Future transfers out of the fund
- Years to retirement.

The Board has assessed the value of these rights as equivalent to an average 17.5% uplift in policy values, comprising a 16.2% increase in guaranteed benefits and a 1.3% increase in the non-guaranteed policy value arising from the Halifax money if the CSP is approved.

A.20 The apportionment of GAR rights between different classes of GAR policyholder is based on legal rights in terms of the similarity of the interest rate guarantee within each class of policy and on whether there is an option to choose a flexible form of GAR annuity.

A.21 The Board argues that the CSP satisfies the principles in respect of non-GAR policyholders since:

- It involves fair value compensation to the non-GAR policyholders based on the 'uncertain prospects' of their potential claims;
- The compensation takes the form of a proportionate increase in non-GAR policyholders' policy values and an addition to guaranteed benefits to compensate for the guaranteed bonuses that would reasonably be expected in the absence of the House of Lords ruling
- The compensation to non-GAR policyholders should be paid for by a proportionate reduction in the increases to GAR policyholders.

A.22 The Board has valued the non-GAR rights on the basis of the following factors:

- Total potential claims of £850mn (5% of the non-GAR share of the with-profit fund)
- A potential discount of up to 75%, since 75% of the with-profit fund is already owned by non-GAR members
- A potential discount to account for the probability of claims being successful, estimated at between 20% and 70% (however, the Board claims that there is insufficient time to bring a test case before 1 March 2002, the deadline for the receipt of the Halifax £250mn).

The Board has assessed the value of these rights as equivalent to a 2.5% uplift in policy values, comprising a 1.4% increase in guaranteed benefits and a 1.1% increase in the non-guaranteed policy value arising from the Halifax money. The guaranteed values of with-profit pension policies entitled to guaranteed bonuses (including with-profit annuities) will increase by 4% (or by 0.5% for those that have already benefited from a 3.5% increase via a GIR). If the non-GAR policyholders vote for the CSP, they give up potential claims of £850mn in exchange for £220mn compensation, a net transfer of funds to GAR policyholders of £630mn.

A.23 The free assets (i.e., surplus of assets over liabilities) of ELAS are estimated to improve by over £1bn if the CSP is approved (less if the £250mn payable by Halifax is foregone). The Board argues that an increase in free assets will allow greater investment freedom which would permit a greater weighting in equities. **However, in the short term, on account of the high level of guarantees currently in the with-profit fund, investment freedom is likely to remain highly restricted.**

A.24 In the event of the CSP not being approved at the vote on 11 January 2002, the Board considered the following options:

- Option 1 – Maintain the current position, matching the GAR liabilities with hedging instruments
- Option 2 – Entering bilateral agreements with policyholders

- Option 3 – Apply to the court for a ‘reduction of contracts’ under Section 58 of the Insurance Companies Act 1982
- Option 4 – Make amendments to GAR policies during the course of a Schedule 2C Insurance Companies Act 1982 transfer or a Section 112 Financial Services and Markets Act 2000 transfer of the with-profit business to a third party (including a specially formed company or special purpose vehicle)
- Option 5 – Liquidate ELAS

A.25 The Board decided not to recommend any particular one of these options in the event of rejection of the CSP and it argued that each of them had disadvantages. For example:

- in the case of Option 1 – reserves would have to be set aside both to meet the potential claims of the non-GAR policyholders and to provide a hedge for the GAR liabilities and these reserves would have to be invested in highly liquid fixed-income securities with lower long-term returns than equities
- in the case of Option 2 – the differences of interest between different classes of policyholder or indeed between different policyholders might be so great that policyholders might seek to negotiate individual terms for themselves and this could not be achieved before the 1 March 2002 deadline for receiving the Halifax money
- in the case of Option 3 – unless ELAS was ‘unable to pay its debts’, a court would have no jurisdiction to ‘reduce the amount of the contracts’
- in the case of Option 4 – ELAS has been advised that there is ‘no absolute certainty’ that the court would approve amendments made under these Acts
- in the case of Option 5 – it would be expensive (‘possibly over £100mn’) and is unlikely to benefit policyholders unless it incorporates a compromise solution to the GAR problem

A.26 **In the event of the CSP being rejected, ELAS would have to continue to reserve against GAR liabilities and this would constrain investment freedom not only in the short term but also in the long term, as well as making the financial position of ELAS much harder to manage.** To maximise the certainty of cash flow, a very high proportion of the fund’s assets would have to be held in bonds, rather than equities. Future investment return can therefore be expected to be ‘modest’ until retirement or throughout retirement if a with-profit annuity is taken. Those taking ELAS annuities would be receiving a pension from a provider with a ‘very low credit rating’. The ELAS bonus policy would be based on prudence, i.e., only to pay out contractual amounts as they fall due without any non-guaranteed bonuses being paid. Surrender values would reflect only contractually guaranteed amounts (converted from the earliest maturity date to a present value).

A.27 According to the Appointed Actuary (Report, 22 November 2001, p13, and repeated in the *Scheme Circular*, p104), 'it would only be through action of this nature that the Society could build up significant assets to meet potential legal claims beyond the provisions made. The unfortunate implication of doing so would be to depress payouts for some policyholders, emphasising the inevitable problems in maintaining equity between different groups. The Society's priority would have to be to meet the competing demands of legal claims and paying guaranteed benefits as they become due. Payment of non-guaranteed benefits would be much more uncertain, at least in the short term. The prospects of any discretionary guaranteed benefits would remain remote because of the need to meet the 3.5% GIR, and the already high levels of guaranteed funds'.

A.28 The Independent Actuary, appointed by the Board to consider the 'reasonableness and appropriateness of the actuarial assumptions, valuations and methodologies used by the Society in developing the Scheme and the reasonableness and fairness of the terms of the Scheme (i.e., the CSP) from an actuarial point of view', concluded that 'from an actuarial point of view the terms of the Scheme have been established in a fair and reasonable way' (p43) and that the 'Society has established the GAR cost on a realistic estimate basis' (p18) and warns 'in the event that the Scheme is not implemented, a full reappraisal of the asset mix would be required to establish a long-term stable investment mix which recognises that the GAR problem will be likely to persist throughout the lifetimes of remaining policies' (p8) and as a result will 'cause an unsatisfactory solvency position to persist for the Society' (p10).

A.29 There are a number of ongoing enquiries in connection with this case:

- Herbert Smith – Herbert Smith, the solicitors, have been instructed by the present Board to investigate whether there are any causes of action against former directors, appointed actuaries, auditors, legal advisers or regulators
- Penrose – Lord Penrose has been asked by the government to chair an inquiry into the affairs of ELAS; on 16 October 2001, Ronnie Baird, Director of Quality Assurance and Internal Audit at the Financial Services Authority, published a report on the Financial Services Authority's role in regulating ELAS between 1 January 1999 and 8 December 2000 which has been submitted as evidence to the Penrose inquiry
- Parliamentary Ombudsman – The Parliamentary Ombudsman has instituted enquiries in relation to the Financial Services Authority's role as regulator of ELAS
- Treasury Select Committee – Subsequent to its Interim Report on Equitable Life and the Life Assurance Industry of 10 March 2001, the Treasury Select Committee will report to the House of Commons on the 'key factors explaining its [Equitable's] recent problems'.

Appendix B: Documents used in this Assessment

Proposed Compromise: Ready for Your Comments, Equitable Life Assurance Society, September 2001.

Background to the Proposed Compromise, Equitable Life Assurance Society, September 2001.

Scheme Circular, Equitable Life Assurance Society, December 2001.

Your Questions Answered, Equitable Life Assurance Society, December 2001.

Interim Report for the Half Year Ended 30 June 2001.

Report of the Appointed Actuary of the Equitable Life Assurance Society on the Proposed Scheme of Arrangement under Section 425 Companies Act 1985, 22 November 2001.

Report of the Independent Actuary on the Proposed Scheme of Arrangement under Section 425 Companies Act 1985, November 2001.

Appendix C: About the Author of this Report

Dr David Blake is Professor of Financial Economics at Birkbeck College in the University of London and Chairman of Square Mile Consultants, a training and research consultancy. Senior Research Associate, Financial Markets Group, London School of Economics. Senior Consultant, UBS Pensions Research Centre, London School of Economics. Research Associate, Centre for Risk & Insurance Studies, University of Nottingham Business School. Formerly Director of the Securities Industry Programme at City University Business School and Research Fellow at both the London Business School and the London School of Economics. Consultant to many organisations, including Merrill Lynch, Deutsche Bank, Union Bank of Switzerland, Paribas Capital Markets, McKinsey & Co., Financial Research Services Ltd, James Capel, Schroders, Browne Jacobson Solicitors, Taunton Cider Company, Hill and Knowlton, the Independent Television Companies Association, the Office of Fair Trading, UNESCO and the World Bank.. External Examiner for the Wholesale Markets Brokers Association Diploma. Registered as an Approved Person with the Financial Services Authority.

David Blake was a student at the London School of Economics in the 1970s and early 1980s, gaining his PhD on UK pension fund investment behaviour in 1986. His research interests include the modelling of asset demands and financial innovations, the investment behaviour and performance of pension funds and mutual funds, and pension plan design. He has published in major economics and finance journals in all these fields. He is author of ***Financial Market Analysis*** published by Wiley in 2000, ***A Short Course of Economics*** published by McGraw Hill in 1993, ***Modelling Pension Fund Investment Behaviour*** and ***Issues in Pension Funding*** both published by Routledge in 1992, and ***Pension Schemes and Pension Funds in the United Kingdom*** published by Oxford University Press in 1995. Professor Blake gave evidence to the Goode Committee in March 1993 and was a member of the Retirement Income Working Party which published its report ***Improving Security and Flexibility in Retirement*** in March 2000.

In June 1996, he established the Pensions Institute at Birkbeck College. The Pensions Institute undertakes high quality research on all pension-related issues and publishes details of its research activities on the internet (http://www.pensions-institute.org). The Pensions Institute was the first academic research centre devoted exclusively to studying pensions matters to be established outside the US.

David Blake regularly speaks at international conferences on pensions and pension fund management in the UK, Europe, the Far East, Australia and the Americas.

The author is not a member of the Equitable Life Assurance Society.

Appendix D: About the Equitable Members Action Group (EMAG)

EMAG was formed in the immediate aftermath of the House of Lords ruling, in August 2000, as a policyholder action group.

EMAG is dedicated to promoting the best interests of ALL policyholder classes in the Equitable Life. EMAG is totally independent of any commercial organisation and is funded solely by members, with a joining fee suggested of £20.

It is the only group that is 'fully formed', with a constitution, elected committee members, minuted meetings etc. It seeks to be a model of transparency to the Society and it disseminates information largely through its own website.

It has never been EMAG's policy to advise members on personal financial decisions. Rather, it has sought out information to facilitate more informed personal financial decisions by policyholders.

However, the committee endorses the view that the achievement of a fair and just compromise would provide the Society with much needed stability and should lead to better future bonus prospects.

EMAG has therefore elected to spend the majority of its available funds on this Report by Professor David Blake to seek reassurance for ALL policyholders that the compromise scheme is adequate and objective.

The Report should provide a much-needed totally objective insight from a different perspective, thus aiding policyholders to make more informed voting decisions at this difficult time.

No influence of any kind has been brought to bear on Professor Blake and the views are his alone and are neither influenced by nor endorsed by EMAG.

Paul Braithwaite
Chairman of EMAG
www.emag.org.uk