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Origins and Nature of the Equitable Disaster

A submission to the EQUI Committee of the European Parliament, presented by Michael Josephs on behalf of Investors Association[1]

1. **Madame Chairman, we are honoured to respond to the Committee's request to submit evidence relevant to its mandate and the collapse of Equitable Life. As a result of nearly five years of investigation and discussion we have formed a number of conclusions which go beyond what Lord Penrose felt able to say, and which we hope will assist the Committee in charting the path of its own inquiry. However, these conclusions are based on the very limited set of facts which have come into the public domain; they are plausible and mutually consistent, but they cannot be final and definitive.**

2. **Investors Association has reviewed the EMAG Petition to the European Parliament and endorses that document as a careful and accurate summary of the proven evidence in the matter. We have tried in this brief to complement that Petition with a discussion of the regulatory culture of the UK Industry as well as some deeper background to what happened at Equitable.**

3. **In particular, we have grave doubts as to whether any one of the three EC Life Directives was or could have been successfully transposed into the UK regulatory environment, given the differences of 'philosophy' between the Commission's intentions and the way in which the UK system actually worked[2].**

4. **We have also tried to keep this submission as short as possible by confining it to fundamentals, especially those not covered by previous evidence to this Inquiry. We will be happy to expand on any matters which the Committee wishes to clarify further.**

The Cover-Up

5. **We find that there has been a consistent pattern of misdirection and concealment of relevant information about the Society's activities, on the part of Equitable itself, the Insurance Industry and the responsible Government departments, and this 'cover-up' has been in place for at least 20 years. In the process a succession of 'false trails' have been laid in order to compromise any investigations. The cover-up has been remarkably successful in confusing and silencing both policyholders and the UK media.**

6. **Investors Association believes, but cannot prove, that this cover-up was orchestrated by senior elements in the Actuarial Profession (12 below). This would have been facilitated by the fact that the majority of 'Lifecos' [Life Assurance Companies] were controlled by senior actuaries.**

The UK Insurance Environment

7. **In the 1970s, UK Life Assurance was still dominated by mutual organisations, which were largely immune to competitive pressures, and jointly behaved like a collective social organism. The Government Actuary's Department [GAD] was allowed to be part of this organism rather than standing above it.**

8. **In the same timeframe, the old culture of benevolent concern for the interests of the policyholder gave way progressively to an attitude of cynical exploitation of the layman's naïve trust in the Insurance Industry and his (or her) ignorance of its complexities, particularly those associated with 'with-profit' funds.**

9. **There was also a massive increase in the direct business leverage of the UK Life and Pensions Industries. Between 1963 and 1980 their combined share holdings in quoted companies rose from 15% to 47% by value. Where they chose, they could directly influence company behaviour.**

10. **The details of the UK's Regulatory Structure on the prudential side are by now so familiar that they are accepted uncritically. But if we re-examine that system to ask how much of it the Regulator actually controlled, we find ourselves faced with something that defies credibility.**

11. **The essential elements were the Regulator at the Department of Trade, the technical agency - the GAD, the Actuarial Profession which wrote the standards and the Appointed Actuary who worked for the Lifeco and had to implement the standards. All of these parties had to work effectively in concert in order to deliver the regulation prescribed in the Statutes. Their allegiances were roughly as follows:**

	Allegiance to the Regulator	**Blurred Allegiance**	**Allegiance to the Lifecos**
	The DTI itself	**The Government Actuary's Department	The Actuarial Profession
			The Appointed Actuary
		***note: Administratively the GAD was an agent for the DTI, but its technical allegiance was to the Actuarial Profession.*	
	Conclusion:	**The official Regulator, the DTI, controlled only one of the four elements necessary for proper regulation: - Itself!**	

Table A: Patterns of Allegiance

The implications are obvious - the system could not work without the active consent of the Lifecos. IA concludes that the UK prudential system was designed to give the appearance of proper regulation, but left effective control in the hands of the Life Assurance Industry.

12. **The degeneration of the UK's Actuarial Profession forms an inseparable but complex part of this story. Essentially, from around 1970 the Profession abandoned all sense of public duty and its role of policyholder protection in favour of concentrating on advancing the interests of its own members. It regressed from being a profession to acting as a guild. In the end it had to suffer a compulsory programme of reform as directed by Sir Derek Morris.[3]**

Equitable Life Itself

13. **The evidence indicates that the UK's prudential environment was deliberately weak, from at least 1975 onwards, but it is clear that Equitable was unique in the extent to which it actually exploited these weaknesses. Other Lifecos at least gave lip service to the traditional disciplines of running with profit funds (which were the source of 90% of the difficulties that policyholders were to experience).**

14. **By 1970 Equitable was largely dependent on its business from the University retirement fund, and this business was in terminal decline.**

15. **During the 1970s, personal tax rates were very high, but life assurance premiums were largely exempt. This made such premiums an important part of tax avoidance strategies for high income earners. Only Equitable and the UK tax authorities know how much premium income arose from this source, and what special terms were offered.**

16. **IA believes that customers of this type, and the consulting actuaries who advised them, constituted a completely separate segment of the Society's business, and that this segment received 'special treatment' over an extended period of time. (32 below)**

17. **The Directors of a mutual Society have a fundamental legal duty to apportion trading profit and investment growth 'fairly' as between different groups of policyholder. This duty was effectively ignored by Equitable Life and was not enforced by the Regulators.**

18. **It had become customary in the Life Industry to manipulate terminal bonuses to improve relative performance rankings. Such bonuses only appeared in the Accounts when actually paid, not when declared. Equitable added its own form of 'final bonus' year by year for the period 1981-1985 until policy values grossly exceeded assets, thereby creating an essentially false performance picture. It appears that the primary purpose of this innovation was to evade the already weak prudential regime. The Regulator should have recognised this intention but apparently did nothing to counter it.**

19. **The effect of the deliberate 1981-85 overbonusing was to make promises of grossly inflated future payouts on those policies already in existence in 1980. By contrast policies which started in 1985 and later received negligible benefit.**

20. **In the same timeframe Equitable introduced a simplified bonus allocation scheme which made their WP Fund appear very similar to a conventional 'mutual' or 'unit linked' fund. The similarity was almost totally illusory, as the fund contained only about half the assets of a proper mutual fund. The new system, later codified in "WPWM"[4], abandoned all reliance on 'fair asset share', <u>and made it infeasible to correct the excessive bonus allocations to the pre-81 cohort.</u>**

21. **Under the WPWM system as actually operated, Equitable Life ignored the very substantial amounts of final bonus already advised to policyholders when deciding how much new guaranteed bonus could be declared. They then added further 'final bonus' on top of that, based almost entirely on what was needed to appear 'competitive'.**

22. **It can readily be seen that such a system is grossly unstable, even at steady levels of new business since it progressively erodes any remaining capital. It also unfairly favours contracts approaching maturity, and it is therefore extremely risky for policyholders whose contracts will not mature for many years.**

23. **Almost nothing is known about the Regulatory response to these events, as all relevant regulatory files prior to calendar year 1989 were destroyed in 1991, an act for which there has never been a satisfactory explanation.**

24. **It was established practice for Lifecos to hold substantial unallocated reserves, or 'free estate', to serve as a cushion against commercial or market downturns. During the same 1981-85 period Equitable used all of its estate and later declared that it had no need of such reserves. The implications of this declaration were concealed from policyholders.**

25. **The Judicial Inquiry under Lord Penrose was not provided with adequate information about the figures for the 1980-90 period. His report does not quantify the realistic asset shortage at the end of 1985, but it has been estimated (using crude financial models of my own devising) at around £1.5 Billion on an asset base of £3 Billion. This asset shortage, deriving from overbonusing a particular cohort, inevitably undermined the finances of the Society within a few years as the 'fortunate' policyholders withdrew their funds.**

26. **Given the dearth of information in Equitable's published accounts, only an insurance expert familiar with "WPWM" and adept at forensic accounting could assess the high risks attaching to its policies. This was a situation calling for firm regulatory intervention, but there was no such intervention.**

27. **On the contrary, Equitable was allowed to conceal its selective overbonusing in the 1980s as well as the consequences of its reckless and dangerous series of innovations.**

28. **In financial terms, Equitable was exceptionally weak, even by the standards of UK mutuals. By 1990, long before the GAR crisis struck, it had blocked off all conventional routes to recovery. But the Regulators deferred to Equitable's management again and again. It is clear that enforcement action was not on their agenda. In effect Ranson[5] regulated the GAD, not vice versa.**

29. In 20 above we drew attention to the improper preference given to the 1981-85 cohort. In effect, Equitable insisted on treating all policies alike, whether they were written as 'defined benefit' contracts, or in the later form as 'investment' contracts. IA believe that the latter contracts (the great majority of those in force by the year 2000) were written so as to give their holders the absolute right to share in the investment return of the Society <u>pro rata to net premiums paid</u>.

30. According to the EC life directives (see endnote 2a), such a right should have been reflected in the calculated liabilities for those policies but that was not the case. This reduced the calculated liabilities of the Society by many £Billions, and enabled the continued transfer of assets from holders of the newer policies to the favoured cohorts.

31. The 'GAR crisis' was long in developing but became publicly visible only in 1998. Essentially, many of the policyholders who had received excessive bonuses in the 1980s were demanding an even larger share of the common pool. Equitable lost the case because they were not prepared under any circumstances to reveal how the finances were undermined originally.

32. There were many mistakes and changes of course between the emergence of the GAR problem in 1993, the failure to sell the Society in 2000 and the Scheme of Arrangement in 2002, but two overlapping groups of policyholders received consistent preference: those whose excessive bonuses in the 1980s had effectively destroyed the Society, and those whose business was on a large enough scale to act via the agency of consulting actuaries. Both groups were protected and favoured so that all the losses fell on the ordinary policyholders.

33. It appears more than probable that the whole Insurance establishment has colluded with the Society to suppress the key facts of how the Society was weakened in the 1980s and who then benefited from what had been done. The Regulators appear to believe that they are justified in such implicit falsehoods by the need 'to preserve confidence'.

34. It is notable that the Society and the Regulators are still denying that there was consistent overbonusing, while suppressing the evidence that would allow the matter to be resolved by open discussion. Such behaviour and all the related concealments have not 'preserved confidence' at all, but certainly have the effect of protecting the incompetent and the corrupt.

35. The Committee of Inquiry is invited to examine whether such a consistent pattern of concealment and misdirection is or should be compatible with the regulatory regime implicit in the EC Life Directives.

36. Finally, IA have noted that there is an interesting similarity between the Equitable situation and that of more than 85,000 UK citizens who have lost all or part of their occupational pension entitlement. In both cases, UK Governments (Labour and Conservative) seems to have yielded to pressure from big business to weaken the protection afforded to policyholders. Is it a coincidence that in neither case did they communicate the greatly increased risks to the individuals affected, and that in both cases they appear to have bypassed EC Directives in order to do so?

ENDNOTES

[1] Investors Association is a lobby group which campaigns on behalf of the private investor and consumer of financial services. It has taken a close interest in the causes of the Equitable Life collapse and contributed to a number of the associated investigations. Its primary presence is its website www.investorsassociation.org . Michael Josephs acts as its principal researcher into Equitable matters.

[2] In our very preliminary view, the key clauses of the Life Directives in relation to the UK Implementation include the following:

a) those clauses requiring the terms of contract to be carefully assessed in computing the liabilities; (Article 20.1A [Article 17 in First Directive])
b) the clause requiring bonuses to be awarded on a 'progressive basis', and for allowances to be made for the right to future bonuses; (Article 20.1A [Article 17 in First Directive])
c) the clause requiring the inclusion of all forms of bonus whether ***"awarded, allotted or allocated"*** in the computation of liabilities; (Article 20.1A [Article 17 in First Directive])
d) the paragraph in the prologue describing the purpose as ***"to guarantee for policyholders an adequate degree of protection" (para 5);*** the word 'guarantee' precludes laissez faire behaviour in our opinion;
e) the requirement to ***"verify the financial information"*** presented by the Lifeco, which is normally interpreted as conducting audit like checks on such data; (Article 11, [16 in First Directive])
f) the requirement to ensure sound administrative procedures and adequate internal controls. (Article 10, [15 in First Directive])

[3] See http://www.hm-treasury.gov.uk/media/CA0/9C/morris_final.pdf "Final Report of the Morris Review of the Actuarial Profession"

[4] See "With Profits Without Mystery" by Roy Ranson and Christopher Headdon, presented to the Actuarial Profession in London (1989) and Edinburgh (1990). [Formatted by IA as a Microsoft Word document]: http://www.users.bigpond.com/dean_em/documents/wpwm.doc

[5] Roy Ranson, the Chief Executive and Appointed Actuary