

Please note

The telephone numbers of the Parliamentary and Health Service Ombudsman changed on 15 March 2009.

The new contact details are:

Helpline: 0345 015 4033

Fax: 0300 061 4000

Section 4

Documents setting out responses to the report

Responses from individual regulators/actuaries

Scrutinising Actuary E

Memorandum of Scrutinising Actuary E to the Parliamentary Commissioner for Administration

1. I am a retired actuary. In the latter part of my career I was a member of the Government Actuary's Department ("GAD"), and from 1996 to 2000 I was closely involved in the supervision of the affairs of the Equitable Life Assurance Society ("Equitable"). In that connection I was interviewed by representatives of the Penrose Inquiry into Equitable, and I made a lengthy statement for that Inquiry. I refer to that statement (which I presume is available to the Parliamentary Commissioner for Administration – "PCA") and I shall not repeat its contents in this Memorandum. I do however wish to draw to the attention of the PCA, and expand a little upon, certain observations that I made towards the end of that statement ... headed – "The Law Lords Verdict".
2. I remain of the view that the arguments and themes that I presented in that passage are worthy of proper consideration, and I am of the opinion that these points have not received the full consideration that they deserve. In presenting these arguments and themes I should emphasise that these are my own personal views, and are not presented on behalf of the GAD or any other Government Department.
3. I recognise that it is no part of the PCA's brief to revisit the judgment of the Law Lords, but in my view it has to be acknowledged that it was the unexpected financial impact of their judgment that brought about the demise of Equitable. Even with full knowledge of the events which have happened since the demise of Equitable and the matters which have been investigated, I remain convinced that had the judgment of Lord Justice Scott been supported on appeal, Equitable would still now be open for business and serving its members fairly.
4. I also realise that the underlying pension contracts issued by Equitable, that were the basis of the Court Hearing, were not happily drafted, but I am confident that the bonus policy being applied to them by the Board of Equitable, acting on the advice of their Appointed Actuary, was fair and equitable. That policy was in line with insurance legislation and actuarial and regulatory guidance, and to the best of my knowledge was properly operated under the terms of the Articles of Equitable. These Articles naturally supported the idea that bonuses should be allocated by the Board on the advice of Equitable's Actuary in the light of the surplus shown as emerging. The bonus policy ultimately insisted upon by the Law Lords took no account of the emerging surplus, but involved the payment of enhanced benefits to one major group of policyholders (i.e. those with GARs) in excess of their "asset shares", to the inevitable detriment of the Reasonable Expectations of all the other participating members of Equitable. Following this judgment, no other business could fairly be written and closure necessarily followed.
5. In order better to illustrate the dramatic financial impact of this bonus judgment, I offer the following simplified example:–

A policyholder may have contributed, say, £60,000 to his pension contract. In the 1990s his notional accumulated fund (his asset share) might have risen in value to £100,000, at a time

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when long Gilt yields were in the region of 7%. This yield might be found adequate to support the prospective lifetime payment of an annuity to the policyholder at the minimum rate guaranteed in the contract. At this point Equitable might have notified the member that his guaranteed fund had accumulated to £80,000, but that there was also an accrued non-guaranteed terminal bonus of a further £20,000.

Without further contributions, the stock-market moved up sharply to a level where the notional asset share of the policyholder had grown to £140,000 – but long Gilt yields were now only 5%. At this point Equitable told the policyholder that his non-guaranteed terminal bonus had risen to £60,000, but that it would be reduced if he elected to take advantage of the GAR.

In practice, a fixed annuity for life as offered by the GAR is not considered to be very attractive unless health is poor, so most policyholders would happily elect to take the enhanced lump sum benefit of £140,000 and buy either an index-linked or a with-profit annuity with the proceeds.

6. A situation similar to this example prevailed for several years during the 1990s. Operating a two-tier bonus policy in this way was consistent with all industry practice at this time.
7. The judgment of the Law Lords that effectively required Equitable to pay a life annuity at the minimum guaranteed rate based on the enhanced lump sum benefit of £140,000, actually required Equitable to find about £196,000 to secure a yield of 7% on £140,000.

(An income of 7% of £140,000 is £9,800, and, with gilt yields now only 5%, to obtain this income required the investment of the much larger figure.) Thus, an additional £56,000 had to be found, inevitably by taking it away from the “asset shares” of other policyholders.

8. The Penrose team ignored the fact that this judgment had dramatically changed the financial situation of Equitable - in a way that was unpredicted and unpredictable. The worst court judgment that I had anticipated was that Equitable had failed to explain adequately its bonus policy to members in the past. Management might then be admonished and some compensation might have needed to be paid to certain policyholders. The existing bonus policy would be sustained, but better explained. In the event, the changed bonus policy actually insisted upon by the Law Lords was inequitable and financially unsupportable.
9. By ignoring this fundamental factor behind the financial distress of the Society, and by constructing instead an explanation based upon alleged inadequate reserving and over-bonusing by Equitable and its Actuaries in the 1990s, the Penrose team in my view grossly misrepresented the true position.
10. It seems to me that the PCA is now in danger of repeating this flawed process, with detailed research into the supervision process conducted by GAD during the 1990's. Having seen the evidence collected by the PCA, I do not consider that any significant shortcomings are disclosed, and certainly none which affected in any way the ultimate outcome of events.

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11. As with the Penrose team, the persons carrying out the current investigation demonstrate little appreciation or understanding of the nature of a with-profit life assurance operation. Since a with-profit fund should be virtually immune from potential insolvency, the reserving process involves essentially a judgment about timing the emergence and distribution of surplus. The Valuation Regulations were largely drawn up by the team at GAD and I believe that their operation was handled by a very professional group. It was not the job of GAD or the supervising authority to manage companies under their care, but we always did our utmost to encourage good practice.

been replaced by new reserving requirements, that are in my view unnecessary and unrealistic. These reserves, with the additional minimum solvency margin also required, result in it being very difficult for a with-profit fund to invest in lower yielding equities or property - so that very limited sources now exist for future surplus to emerge from growing asset values.
12. I do not consider that it would have been open to us or reasonable for us at any time to have insisted that additional reserves be established to meet what turned out to be required by the ultimate Law Lords' Judgment. The actual tight balancing act being sustained by the Actuaries at Equitable was fully understood by GAD and the regulator, Equitable's policyholders and the market as a whole. Equitable was always extremely open about, and indeed proud of, its desire not to carry forward a large estate to the detriment of payouts under maturing contracts. I firmly believe that, prior to the final judgment of the Law Lords, all informed observers would have thought it improper and inequitable to establish reserves for such a remote and unlikely contingency.
13. The change in industry practice which has followed from Penrose, to require the holding of stronger reserves by with-profit life funds, has had the inevitable effect of virtually killing off participating life assurance business. The previously existing careful balancing act has
14. I stress again that these are my personal views, though I know that they are shared by others.

Further Note by Scrutinising Actuary E

I consider it necessary to expose the judgment of the Law Lords' as financially illiterate and partial, and to speak out in defence of the sound and effective appointed actuary system historically adopted in the UK to control the operation of Life Assurance Funds.

With profit funds in the UK were able to invest effectively to achieve maximum long term investment returns precisely because the contracts contained minimum guarantees regarding the benefits being promised. The Law Lords chose to overlook this long established and accepted position, (as embodied in the Articles of the Society - that all bonus additions are at the discretion of the Board acting on the advice of the Actuary), and effectively revised the terms of these contracts by reading into them wider guarantees than had been previously understood and recognised. The contracts certainly never included any premium loadings to cover promises to the extent that the Law Lords deemed were included in the GAR policies.